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OPERATION OF THE CARRYBACKS OF WORLD WAR II DURING THE RECONVERSION PERIOD

E. CARY BROWN AND RICHARD ECKAUS *

I

BACKGROUND FOR THE CARRYBACK ADJUSTMENT

THE EXCESS PROFITS TAX of World War II had largely taken shape by 1942. While debate had centered on the nature of this tax in the earlier legislation, the Revenue Act of 1942 was marked by substantial increases in the excess profits tax and, in an even more outstanding way, by the attention given to the refining of what was to be taxed as excess profits. Not only were changes made in the determination of the amount of income that was to be exempt from the excess profits tax, but careful consideration was also given to the determination of income itself—the proper relating of costs to the revenues with which they were associated. At the rates of excess profits tax then proposed, careful definition of income was urgent; otherwise, the tax might have fallen on a nonexistent or ephemeral income and have raised serious equity and economic problems.

A. *Proper Allowance for Reconversion Costs*

A particularly difficult problem in defining excess profits arose in connection with the costs of reconverting to peacetime production.[1] These costs would not be incurred by firms until after the war had ended and the reconversion period begun. Yet they represented a part of the cost of wartime production.

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[1] For a detailed discussion of these problems see U. S. Treasury Department, Division of Tax Research, "Postwar Expenses Related to Wartime Income," in U. S. House of Representatives, Committee on Ways and Means, *Hearings on the Revenue Revision of 1943*, pp. 135-169.

Types of reconversion costs. The process of reconversion was expected to create a number of these costs. For example, *inventory losses* in the reconversion period could result from price declines or from inventory obsolescence. To the extent of these losses, wartime costs would have been understated. The determination of wartime income assumed that the value of wartime inventories was at least equal to their cost. A fall in prices in the reconversion period would prove the assumption to be incorrect. Wartime accumulation of *deferred maintenance* resulting from material and labor shortages would have to be made in the reconversion period. Such abnormal postwar maintenance would represent a cost of earning wartime income. *Rearrangement of plant* from wartime to peacetime production would also take place primarily in the reconversion period. The resulting costs would be allocable against wartime income on the assumption that the firm made a round trip into wartime production. Many war firms promised *dismissal wages* upon termination of employment in order to induce labor to move into war work. These payments actually represented a deferred adjustment of wartime wages and could properly be treated as a true war related expense.

Types of adjustment for reconversion costs. These examples just given represent some of the reconversion costs as they were discussed in the war period. While it was fairly generally agreed that such costs were properly considered as reductions in wartime taxable income, no obvious tax technique for so treating them seemed to be available. While the tax laws permitted accrual methods of accounting, they had usually not allowed the accrual and deduction of costs that had not yet been incurred.[2] Moreover, when these costs were incurred, they could not be deducted from past income but instead were allocated to current or future income. Statutory sanction, therefore, seemed necessary to make a proper tax allowance for these reconversion costs.

The type of allowance that should be made was debated in 1942, and with even more vigor in 1943. One school of thought favored a policy of estimating the amount of future reconversion costs and deducting these amounts from wartime incomes. Later, when the actual reconversion costs had been incurred, they would be offset against this accumulated reserve rather than deducted from reconversion-period income. Another group recommended the direct allocation of reconversion costs against wartime income after they were actually incurred. Under this proposal, no estimates of future reconversion costs would have to be made and no reserve would have to be accumulated.

Either approach had certain weaknesses. There were fears that creation of a reserve for *estimated* reconversion costs would stimulate firms to recapture it in the postwar period, either through inflation of expenses or a broadening of the concept of reconversion costs. Indeed, these fears were so strong that they led to the rejection of the reserve approach in favor of the allocation approach.

[2] The treatment of bad debts, specifically dealt with by statute, represented an exception. Estimated bad debts could be deducted currently in the determination of taxable income.

Under the allocation approach reconversion costs would be carried back and offset against wartime income. But before reconversion costs could be carried back against wartime income, they had to be specifically ascertainable. They would have to be not only precisely defined but reasonably determined. While some costs of reconverting (dismissal wages, for example) could meet these tests, others (such as deferred maintenance) could not. There were fears that attempts to administer the adjustment of specific reconversion costs would bog down in controversy and litigation. Some alternative was clearly needed.

After considerable discussion, a general carryback of reconversion costs was adopted—the two-year carryback of losses and unused excess profits credits. It avoided measurement of specific costs by adopting the presumption that deficiencies in " normal " profits in the reconversion period were the *result* of reconversion costs and losses.

Such a presumption, obviously, could be inaccurate. In the first place, the definition of " normal " profits adopted in the law was that of the excess profits credit. In some cases this credit represented a considerably larger amount than the firm could normally expect to earn; in others it was too low. When the excess profits credit was too high, a return to true normal profits in the reconversion period would give rise to a carryback whether or not the firm sustained reconversion costs and losses. When the excess profits credit was too low, some portion of a firm's reconversion costs would not be offset against wartime income through their failure to pull normal profits below the excess profits credit.

The second major weakness of the carryback presumption was that reconversion period income might not be equal to normal profits minus reconversion costs. Abnormal reconversion period costs might bear no relationship to reconversion proper; they could, instead, be related to current or future income, like the costs of introducing a new product, or abnormal research activity. Abnormal income arising from pent-up consumer and business demand might be so large as to absorb reconversion costs; the resulting profits might still remain above the normal level.

The two-year carrybacks by no means provided, or were thought to provide, a perfect adjustment for reconversion costs. They were adopted despite their known weaknesses. Some adjustment seemed necessary, and the carrybacks appeared to Congress at that time as a satisfactory method of adjusting wartime income for reconversion costs.

B. *Provision of Reconversion Working Capital*

Besides creating a problem of income allocation, reconversion costs imposed a financial drain on the firm's resources in the reconversion period. These working capital needs were not adequately met by the carrybacks as originally enacted. Under the original law tax refunds from the carrybacks could not be paid until the wartime tax returns had been finally audited. Since the time involved would necessarily have been long, firms would have been forced to borrow these estimated tax refunds, and banks might have been reluctant to lend.

By 1945, however, legislation was passed that made possible prompt tentative tax refunds to firms with carrybacks.[3] This provision virtually eliminated the need for borrowing to finance potential carryback refunds.

Following enactment of the carrybacks in 1942, they were subjected both to praise and criticism. It was charged, on the one hand, that these provisions stimulated wasteful spending, subsidized business firms which prolonged strikes, and encouraged the distribution of dividends through tax funds. On the other hand, it was held that they considerably improved the operation of the high wartime excess profits tax through the allocation of reconversion costs against wartime income and sped reconversion to high-level peacetime production.

Despite this clash of opinion, no detailed study of the operation of the carrybacks in the reconversion period has been made. We believe that this represents an unfortunate omission. First, the magnitude of carryback refunds in the reconversion period was large and could have had a substantial impact on certain industries and firms. Second, an excess profits tax was enacted again in the current mobilization effort. Reconversion costs raise the same problems for it as were raised in World War II. We should profit from the experience gained by the tax policies in that war.

In this study we have attempted an appraisal of the carrybacks in terms of the purposes for which they were designed. First, the available data are examined. Next, an analysis is made, as far as available information permits, of the extent to which the carrybacks could be attributed to reconversion costs. Finally, we examine their broad postwar economic effects.

[3] *Tax Adjustment Act of 1945.*

II

OPERATION OF THE CARRYBACKS

Any appraisal of the carrybacks is handicapped by the absence of adequate data. Data collected and published by the Treasury Department are for the administrative purposes of the Bureau of Internal Revenue. Even though they are the most comprehensive available, these data are inadequate for our purposes. They are not classified by size of assets or income of a firm, by its industry, or the year in which low income created a carryback. We have had to depend on data from corporate reports filed with the Securities and Exchange Commission and the Interstate Commerce Commission. These data are by no means wholly satisfactory. There is no adequate breakdown of the carrybacks between those resulting from losses and those resulting from deficiencies in " normal " profits. Furthermore, the data are primarily supplied by very large corporations, and their behavior may not be representative of the universe of corporations receiving carryback refunds. Nevertheless, since our sample accounts for the bulk of carryback refunds, we believe that the broad picture it presents is reasonably accurate.

A. *Amount of Refund*

We estimate that carryback refunds arising in the period 1945-1947 amounted to $1.8 billion, about four-fifths of which went to industrial corporations and the other fifth to railroads (Table 1). Over half of these refunds were concentrated in the year 1946, with one-fourth arising in 1947.

TABLE 1

ESTIMATED CARRYBACK REFUNDS

ANNUAL AND INDUSTRY TOTALS, 1945–1947

(Dollar figures in millions)

Year of Refund		Industry Group	
Total	$1,840	Total	$1,840
		Industrial corporations	
1945	330	Registered with SEC *	800
1946	1,110	Other †	740
1947	400	Railroad corporations ‡	300

* Compiled from U. S. Securities and Exchange Commission, *Survey of American Listed Corporations*, 1945–1948, Washington, D. C.

† Estimated by applying ratio of 1946 sales of SEC corporations in sample to total corporate sales as reported by the Commerce Department, rounded to nearest $10 million. This estimation procedure, if applied mechanically in 1946, would have indicated an amount as much as $100 million more as a result of a few very large carrybacks in the wholesale industry. Therefore, we have assumed instead that in this year total tentative refunds as given in U. S. Treasury Department, *Annual Report of the Commissioner of Internal Revenue*, for the fiscal year ending June 30, 1946, p. 25, approximated the total claims for refunds which would eventually be filed for 1946.

‡ Estimated from data on individual Class I roads in U. S. Interstate Commerce Commission, *Statistics of Railways in the United States*, 1946, 1947, Tables A–I, and Haskell P. Wald, "Railroads in the Postwar Economy," *Survey of Current Business*, May, 1948, p. 19.

TABLE 2

NUMBER AND AMOUNT OF CARRYBACK REFUNDS, 1945–1947

REGISTERED CORPORATIONS CLASSIFIED BY YEAR AND INDUSTRY

(Dollar figures in millions)

Industry	Number of Registered Corporations in 1946	Registered Corporations with Carryback Refunds		
		Number of Corporations	Number of Refunds	Amount
Grand total	1,836	509	664	$799.4
Manufacturing	1,306	428	580	772.2
Electrical machinery and equipment	83	37	58	116.6
Machinery other than electrical	233	92	128	120.6
Autos and trucks	35	22	34	167.2
Aircraft	19	17	27	166.6
All other manufacturing	936	260	333	201.2
Transportation	63	26	32	16.2
Air	21	13	14	13.3
All other	42	13	18	2.9
Miscellaneous: mining, trade, service, finance, construction and other	467	55	52	11.0

Source: U. S. Securities and Exchange Commission, *Survey of American Listed Corporations*, 1945–1947.

More detailed industry information is available only for the 1,800 corporations registered with the SEC (Table 2). Less than one-third of this group (509 corporations) claimed 664 carryback refunds in the period 1945-1947. These claims totaled $800 million. The average size of refund varied from year to year. In 1945 the average refund was $670,000; in 1946 it rose to more than $1.5 million; but in 1947 it dropped off to slightly over $1 million.

These data show a high concentration of refunds. Four industry groups in manufacturing—electrical machinery and equipment, machinery other than electrical, autos and trucks, and aircraft—received $571 million, about 70 per cent of total carrybacks to all registered corporations for the entire period. In 1945 autos and trucks accounted for more than one-third of total carryback refunds. In 1946 they again had the largest percentage going to any industry subgroup, but the percentage dropped to 23 per cent. In 1947 aircraft manufacture claimed $89 million in carryback refunds—an amount equal to more than half of the total refunds accruing in that year.

TABLE 3

NUMBER AND AMOUNT OF CARRYBACK REFUNDS, 1945–1947

REGISTERED CORPORATIONS CLASSIFIED BY INDUSTRY AND SIZE OF REFUND TO NET WORTH

(Dollar figures in millions)

Industry	Carryback Refunds as Per Cent of Net Worth					
	Under 5 Per Cent		5 Per Cent and under 10 Per Cent		10 Per Cent and over	
	Number	Amount	Number	Amount	Number	Amount
Grand total	408	$266.3	89	$84.0	167	$449.1
Manufacturing	340	256.8	80	75.2	160	440.2
Electrical machinery and equipment	22	4.2	11	29.1	25	83.3
Machinery other than electrical	74	21.6	19	12.3	35	86.7
Autos and trucks	22	121.4	..	...	12	45.8
Aircraft	2	0.2	3	12.3	22	154.1
All other manufacturing	220	109.4	47	21.5	66	70.3
Transportation	21	4.5	6	7.1	5	4.6
Air	5	2.4	5	6.7	4	4.2
All others	16	2.1	1	0.4	1	0.4
Miscellaneous: mining, trade, service, finance, construction and others	47	5.0	3	1.7	2	4.3

Source: U. S. Securities and Exchange Commission, *Survey of American Listed Corporations*, 1945–1947.

In addition to these industry aggregates, an attempt has been made to determine the significance of carryback refunds for individual firms. As a rough measure of "significance," we have related the refunds to the book value of the net worth of each corporation receiving carryback refunds in this period (Table 3). During the years 1945-1947, 22 per cent (167 corpora-

tions) of the refunds by number received by SEC registered corporations were larger than 10 per cent of the recipient firm's net worth. Moreover, the amount of the total carryback refunds received by the group of firms in this category was $449 million or 55 per cent of the total. More than one-third of the number of refunds amounting to more than two-thirds of the total amount of refunds represented 5 per cent or more of the firm's net worth. Unquestionably the refunds were of tremendous importance for some firms and industries. For example, 25 of the 27 refunds received by the aircraft industry represented more than 5 per cent of the net worth of the recipient; indeed, 22 of these were more than 10 per cent of net worth.

Twelve of 34 refunds to companies in the auto industry amounted to more than 10 per cent of their net worth, as did 25 of 58 refunds to companies in the electrical machinery industry. We would expect this type of concentration; these were the industries that faced the more difficult problems in reconverting to peacetime production.

B. *Allocation of Reconversion Costs*

The primary purpose of the carrybacks, as developed from their legislative history,[4] was to provide an adjustment for reconversion costs. How adequately did they perform this function? Did they lead to the distortion of costs in order to secure the benefit of refunds of wartime taxes? Did they reduce output?

[4] For further information, see Treasury study referred to in footnote 1, and E. Cary Brown and J. Keith Butters, *Business Reserves in Present Tax Law*, Planning Pamphlet No. 27, National Planning Association, November, 1943.

These important questions are impossible to answer definitively. The carrybacks represented an indirect adjustment of reconversion costs. They came into play when income fell below " normal " profits. Therefore, they could arise through abnormal reductions in sales, abnormal increases in costs, and through normal profits that fell below an abnormally high excess profits exemption. To determine the effects of the carrybacks on reconversion and other costs requires a knowledge of precisely what firms would have done in the absence of the carryback adjustment. Obviously, this information is not available. We have had to adopt an alternative method—to examine the behavior of certain available key items from income accounts of firms. This examination is confined to SEC firms receiving relatively large refunds—that is, refunds that constituted 5 per cent or more of their net worth. The behavior of revenues and then costs will be studied.

1. *Decreases in revenues.* In many cases abrupt decreases in sales arose in the early postwar period. Since some costs are relatively fixed at least in the short run, mere falling off of sales ordinarily reduces net income. Sales decreases could be attributed to a number of reasons, some of which had only remote connection with the war. They could then give rise to carrybacks that were unrelated to reconversion proper. On the other hand, decreases in sales could also be attributable to the process of reconversion—an hiatus would arise between war and peace output as plant was being rearranged and rehabilitated.

To get some light on the nature of the decline in sales, let us examine the sales patterns of the 171 SEC corporations in

our sample which had 256 refunds at least equaling 5 per cent of their net worth. The sales in 1945 of about two-thirds of these firms declined from their 1944 figures. A much larger proportion with relatively large refunds—80 per cent—suffered decreases in 1946 sales. And, in 1947, this declining sales pattern held for two-thirds of those receiving relatively large refunds.

The dominance of sales reductions as a factor in carrybacks is clearly indicated. But what were the reasons? Because information is simply not available, the extent to which different influences were working must be purely speculative; but the presence of one of these influences—strikes—can be indicated.

(a) We have made a limited survey of one-third of the SEC companies with significant refunds for which 1946 annual reports were available. During that year nearly one-third of these corporations had strikes of varying, and in many cases of unspecified, duration. Even more indicated that they had to shut down because of strikes in suppliers' factories.

The importance of strikes is further emphasized by the fact that the companies receiving the three largest individual refunds in 1946, which totaled $114 million and represented 22 per cent of carryback refunds to all SEC corporations, had long, protracted strikes in that year. The sales of each of these three companies in 1946 dropped by from one-third to one-half of their 1945 sales, with the largest single influence being their protracted labor difficulties. Strikes clearly were a major factor in reducing revenues and giving rise to carryback refunds in 1946, the major reconversion year.

(b) Sales could also have fallen off through war-created firms converting, rather than reconverting, to some peacetime activity, or because liquidation of the firm took place slowly. This slow pace would permit firms to file claims for refunds of war taxes even though there were absolutely no reconversion costs.

The government attempted to block this use of carryback refunds by denying a full excess profits credit to such firms when they were inactive or were changing the character of their business. Early successes in the Tax Court [5] were subsequently modified or reversed by higher courts.[6] The rule was stretched to such an extent that the mere holding of receivables while the business was winding up was adjudged a corporate purpose for computation of the carryback.[7] Obviously, an excess-profits credit that was proper for an active concern could not fail to be excessive for firms that changed their scale of activity substantially. While judicial interpretation of these provisions gave virtually a blank check to firms, the magnitude of refunds to firms of this character was probably not large.

[5] Wier Long Leaf Lumber Co., 9 TC 990; Rite-Way Products, Inc., 12 TC 475; Gorman Lumber Co., 12 TC 1185; and Winter & Co. (Indiana), 13 TC 108.

[6] U. S. v. Kingman, 170 F 2d 408; and Wier Long Leaf Lumber Co., 173 F 2d 549. The basic rule established was:

> ". . . [I]f it appears that the corporation is a corporation in name and substance only, without corporate substance and serving no real corporate purpose, it must, though not formally dissolved, be treated as dissolved de facto." 173 F 2d 551.

[7] Eastern Grain Elevator Corp. v. George T. McCrowan, U. S. District Court, Western District of N. Y., Nov. 9, 1950.

2. *Increases of costs.* The other major way in which carrybacks arose in the postwar period was through increases in costs. By an examination of some of the cost items on the income statements of those SEC corporations receiving carryback refunds at least equal to 5 per cent of net worth, it is possible to form some judgment about their nature—whether primarily war related or peace related.

(a) One particular type of war-induced costs—acceleration of the amortization deduction for emergency facilities—was the single major factor creating carryback refunds in 1945. In that year 70 per cent of the 171 SEC corporations showing significant refunds had increases over 1944 in depreciation and amortization charges. These widespread increases arose primarily through the shortening of the period of amortization of emergency facilities. By presidential proclamation the five-year period could be shortened so as to end by September 30, 1945. The recomputation of these charges over the shorter period made large increases in depreciation and amortization that created carryback losses or unused credits for some corporations in 1945.

(b) An individual study of each corporation would be necessary before a very satisfactory determination could be made of the fraction of postwar maintenance and repair items that were actually war related. Some insight can be gained, however, from a limited study of the railroads and the SEC corporations in our sample. The major importance of maintenance to the railroads is one reason for taking them up first.

(1) Railroads were the most vigorous proponents of deferred-maintenance reserves to be deducted from wartime income. Because of their method of accounting, their problem was essentially different from that of industrial corporations. They used the retirement method of accounting for track and way accounts. Hence, only *retirement* of track, for example, could give rise to deductible capital expenses. If replacement were limited by wartime allocations, retirements would not be made and maintenance expenses understated. In the postwar period when these accumulated deficiencies would be made good, abnormal retirements of tracks, etc. would overstate maintenance expenses.

The Bureau of Valuation of the Interstate Commerce Commission has made continuing estimates of deferred maintenance for railroads. Their definition of deferred maintenance is as follows:

> Deferred maintenance in this study is an estimate of the expenditures above normal that *should be* and *probably will be* made by the railroads in the near future for the necessary labor and materials to make good the present deficiencies in maintenance (repairs and replacements) that are below normal and to bring their status to a 50 per cent condition on the average. Repairs, like the property to which they are applied, have a service life requiring renewals at certain time intervals and are at 50 per cent condition when half that service life has expired. This deficiency is an estimated future financial liability against the carrier. . . . It is the excess of below normal maintenance over surplus maintenance.[8]

[8] U. S. Interstate Commerce Commission, Bureau of Valuation, *Deferred Maintenance, 1948.* Italics added.

This approach yielded the following amounts of deferred maintenance in various periods: [9]

Period	Total	Average per Annum
1915–1941	$ 0 million	$ 0 million
1942–1945	350 "	87.5 "
1946–1950	600 "	120 "

These estimates are quite striking for several reasons. They indicate that in the postwar period, 1946-1950, there was almost twice as much deferred maintenance accumulated as in the war period, from 1942-1945. Not only were the railroads unable to make good war-deferred maintenance in the reconversion period, but they were unable to prevent a rise in the rate of deferred maintenance. If these estimates are accepted, deferred maintenance could not have been a factor adding to costs and creating carryback refunds for railroads in the postwar years.[10] Nor is the position of the railroads—that deferred maintenance was primarily the result of wartime restrictions—borne out by these data. In 1949 alone, for example, a year in which unemployment was high and materials readily available, the ICC estimates that deferred maintenance increased $300 million.[11]

We attempted alternative analyses by using relations between maintenance and activity developed by the ICC, and also by trying to relate maintenance to railroad revenues both in current and constant dollars. The former method led to quite different results than the direct estimates of the ICC, with no apparent way of reconciling the two techniques. The latter analysis seemed to indicate that the relationship between maintenance and activity has changed several times since 1915. It did appear from all the different investigations that maintenance in 1942 and 1943 was "low," but it does not appear to have affected postwar expenditures to any great extent.

In general, then, we conclude that the large carryback refunds to railroads in 1946 were not attributable to the making good of wartime deferred maintenance.

(2) The industrial corporations used for our maintenance study were SEC corporations with refunds in excess of 5 per cent of net worth. We have limited our analysis to the year 1946—the year of largest carryback refund.

There are many measures of the significance of maintenance, one of which is the percentage relationship it bears to sales. On this basis more than 85 per cent of the SEC firms made good deferred maintenance in 1946 since the ratio of maintenance to sales generally increased between 1945 and 1946. However, as pointed out earlier, general decreases in sales were experienced by SEC firms receiving carryback refunds, especially those with relatively large refunds. These widespread decreases in sales could alone account for the increases in the maintenance-to-sales ratios rather than the making good of postponed maintenance or the insuring of reconversion costs.

[9] U. S. Interstate Commerce Commission, Bureau of Valuation, *Deferred Maintenance, 1947-1950.*

[10] The concept used by the ICC and the estimates which were based upon it are themselves questionable in that they indicate the continuation of deferred maintenance on such a large scale in the reconversion period.

[11] ICC, *op. cit.*

Another measure of abnormal maintenance would be to consider absolute changes in such expenses between the war and postwar period. Twenty-five per cent of the SEC corporations had increases in maintenance and repairs in 1946. But since some of these corporations had increases in sales in the same year, some of the added maintenance would have been related to higher postwar output.

Despite this qualification, could these increases in postwar maintenance have been large enough to account for the carryback that arose? A crude way of determining this (and the only one available to us) would be to assume that the carryback refund approximately measured the amount of the loss and unused excess profits credit combined.[12] Only five of the 152 SEC corporations with refunds in excess of five per cent of net worth in 1946 had increases in maintenance and repairs large enough to have created the carryback refund. And all five of these firms were in the air transportation industry for which the large increases in sales revenues in 1946 indicate additional output and the need for increased maintenance. In 20 other cases the increases in maintenance and repairs were less than 25 per cent of the refund.

Generally, therefore, deferred maintenance seems a relatively unimportant explanation for carrybacks from 1946 for both industrial corporations and railroads.

[12] A refund of excess profits taxes resulting from a loss could equal about 80 to 85 per cent of the loss; a refund of income taxes would equal 40 per cent of the loss; and a refund for an unused excess profits credit would amount to about 40 or 45 per cent of the credit. Therefore, an absolute increase in maintenance and repairs or selling and general expenses, or both, of twice the carryback refund could have accounted for the income deficiency that created the carryback refund.

(c) A broad expense category for which SEC data are available is labeled selling, general, and administrative expenses. Under this rubric will be found the balance of reconversion costs —inventory losses, rearrangement of plant, and research and development. Generally these costs have not been separated; hence our analysis must be based on their total. Nevertheless, it is informative to compare the behavior of these expenses with that of maintenance and repairs. There is evidence of greater postwar expansion in this category than in maintenance and repairs.

For example, almost every SEC firm (98 per cent) had an increase in the ratio of these costs to sales in 1946, as compared with 85 per cent with an increased ratio of maintenance and repairs to sales (see above). Absolute increases in these overhead items were recorded in 1946 for 60 per cent of the firms, compared with 25 per cent for maintenance and repairs. And 21 of the 152 firms had an increase greater than the carryback refund, compared with five firms for maintenance and repairs.

It seems clear, therefore, that responsibility for the carrybacks lay more heavily with these general overhead items than with maintenance and repairs expense. An examination of these companies indicates a rapid expansion of these costs for many firms which, in combination with decreased sales, increased carryback refunds. But even here their importance can be exaggerated. When we combine absolute increases in maintenance and in these overhead costs and compare them with carryback refunds, we find their combined total large enough to account for the carryback in only 18 of the 152

cases analyzed. Moreover, five of these cases were in the air transportation industry which had sharp postwar sales increases.

(1) While a major purpose of the carrybacks was to adjust for inventory losses arising from expected price declines in the postwar period, price rises were more usual than price falls. A few of the SEC companies indicated by footnotes that inventory losses had arisen through obsolescence. But even in these cases, the amounts were not usually very large.

(2) Footnote indications of rearrangement costs showed them to be of minor importance in most cases. A large postwar refund to one company arose because of the expense of moving its offices from the east to the west coast. These costs certainly could not be properly considered as war related.

(3) Another postwar expense closely related to maintenance is that of research and development. Expenditures for this purpose may be charged off in the year in which they are made by firms which follow this policy consistently. Such costs may thus contribute to an income deficiency giving rise to carryback refunds in the reconversion period. Like maintenance, normal research and development could have been deferred during the war with abnormal postwar amounts necessary to bring the firm abreast of its field.

Reliance had to be placed on footnotes in the SEC reports, so, again, complete information is not available. This type of expense seemed to be especially important for firms in the aircraft industry in 1947. Oil refining also required rather heavy development expenses that seemed to increase in the postwar period. But except for these few statements, information is inadequate for further generalization.

Undoubtedly some of these costs were related to peacetime rather than wartime activities. An extreme example of this type was that of a company apparently undertaking development expenses which were carried back against wartime income. The resulting assets were then transferred to another firm that initiated the manufacture of the developed product. Such costs were clearly not related to the earning of wartime income.

III

EFFECTS OF CARRYBACKS ON AGGREGATE DEMAND AND SUPPLY

Did the carrybacks contribute to the inflationary pressures of the postwar period? Did they increase demand for goods and services more than they increased supply? Our conclusions on these important questions must be largely speculative since our data cannot be pushed very far. Nevertheless, we tentatively conclude that, on balance, they increased inflationary resources to some extent.

The carrybacks undoubtedly acted to speed reconversion in some cases and thus contributed to greater output in 1946 than was expected in that year. Moreover, some strikes may have been averted by the prompt granting of wage demands, financed substantially through refunds of wartime taxes. Thus, threatened work stoppages could have been avoided by means of carryback refunds. They may also have induced firms to plan and carry out higher levels of output than would otherwise have been the case. Without

carrybacks, firms might have cut back output more and felt out the postwar demand situation more carefully. But it should be remembered that these increases in output also increased incomes and demand for goods as well as supply. Thus, the reduction in inflationary pressures would come about only to the extent that earners did not fully spend income from the additional output. But on balance, all of these output-increasing factors, even the induced rise in wages that avoided strikes, would be likely to be deflationary.

The carrybacks heightened inflationary pressures to the extent that supplies of goods were reduced or demand for them increased. For example, the carrybacks may have lengthened strikes in some cases. In a test of strength between management and unions, the carrybacks gave firms financial assistance and thus made it possible for them to take a more adamant position. In such situations carrybacks were inflationary —they cut back supply more than demand.

The inflation of certain expenses in the nature of capital outlays also encouraged inflationary pressures. The making good of deferred maintenance, expenditures on research, advertising, etc., and the holding together of a labor force while reconverting, all increased incomes and demand without corresponding initial increases in supply. And, even if no change in output or costs was induced by the carrybacks, the refunds to firms eased their financial problems and made possible greater purchases of capital equipment or more dividends which, in turn, would have increased stockholders' spendable income. As nearly as we can tell, however, dividend behavior was reasonably circumspect. Of the 152 SEC firms receiving relatively large refunds in 1946, 113 of them decreased or held unchanged the amount of dividend payments.

On balance, therefore, the carrybacks appear as a mildly inflationary postwar factor. Our analysis fails to reveal much expense inflation. Our conclusion relies primarily on their effects as a factor inducing longer strikes and in improving working capital of firms.

IV

CONCLUSIONS

From this examination of the carrybacks in the period of reconversion, certain conclusions seem to stand out.

1. It is impressive how unimportant appear to be those reconversion costs for which the carrybacks were specifically designed. Indeed, the costs most emphasized during legislation—inventory losses, deferred maintenance, plant rearrangement—seem too unimportant to have justified special adjustment. Even for the railroads, these costs appeared minor when viewed in the large.

2. Of major postwar importance were declines in revenues, hardly discussed at the time the carrybacks were developed. The loss in sales in the process of reconversion and the cost of rebuilding the productive and sales organization turned out to be more damaging to postwar profits than were the actual costs of plant rearrangement and the like.

3. Strikes were of major importance in reducing the revenues of many firms. Strictly speaking, such decreases in revenues should not have been allocated to wartime income. Losses from strikes could be sustained by firms whether or not they had converted to war work. Indeed, new postwar firms that had no wartime income could sustain losses as a result of a strike in their plant or in plants of their suppliers. Hence, treatment of strike losses as a reconversion cost appears doubtful. While legislation was discussed in 1946 [13] that attempted to eliminate the effects of strikes from the carryback adjustment, no satisfactory adjustment was developed, and none seems feasible.

4. In view of the inability of pinpointing all the possible reconversion costs in advance, the general approach offered by the carrybacks seems more satisfactory than the specific-reserve approach for each type of reconversion cost.

5. Probably the carrybacks should have been repealed by 1947. Most reconversion appears to have taken place by then. The major recipients of carrybacks in that year were aircraft companies. Their income deficiencies did not seem to be related to recovery from war activities but rather to development of peacetime activities.

[13] For example, the LaFollete Bill, H.R. 5220.

6. While a number of examples of expense inflation were encountered, the general picture was certainly not one of sharp expense increases.

7. All things considered, the carrybacks appear to have been mildly inflationary in the reconversion period. In no sense do they appear to have been a decisive factor.

8. In the present emergency an excess profits tax was enacted in 1952. It provided for a one-year carryback of losses and unused excess profits credits. While our study would indicate that a one-year carryback would have been inadequate in the last war, it may be satisfactory for the present limited mobilization. A major effort of the World War II type requires many firms to shut down and to convert to entirely new lines of work. In the present emergency, war output is being fitted into a production schedule that involves substantial amounts of civilian production. Shifts from war to civilian production will not involve the gap in sales that many companies experienced after World War II.

A shift to full-scale mobilization, however, could make the present one-year carrybacks inadequate. A two-year carryback might then become necessary with certain safeguards to eliminate some of the obvious abuses.

CAPITAL GAINS AND THE CHANGING PRICE LEVEL

CARL W. CLOE *

SINCE the inception of the federal income tax in 1913, the problem of taxing capital gains has been sharply underlined by the controversies it has caused and the wide shifts in treatment which such gains have been accorded. The purpose of this article, however, is not to enumerate definitional problems or arguments on percentage inclusion, the long term holding period, alternative rates, or the technique for allowing loss offsets. The subject to be discussed is one particular component of capital valuation, namely, the gains and losses which stem from changes in the general price level.

As developed below, the writer will attempt to demonstrate the relationship between changes in asset values and the general price level and, secondly, a method of materially reducing or eliminating this component from capital gains or losses will be described and analyzed. This method or technique develops the premise, already credited with considerable acceptance in wage and other contracts, that income or gains in any form are meaningful only in terms of a specific price level. The description and analysis involve the application of this principle to equity investments.

The method employed should not be construed as a final tax proposal. In fact, no attempt will be made to examine the numerous equity considerations attending the inclusion of this technique in the general tax structure. Although of great importance, the writer feels that this matter does not properly belong in an initial article on the subject.

Equity securities will be used for purposes of illustration, partly because problems of depreciation,[1] etc. are minimized and partly because of the large volume of capital assets which are owned through shareholdings.

Relationship Between Security Prices and the General Price Level

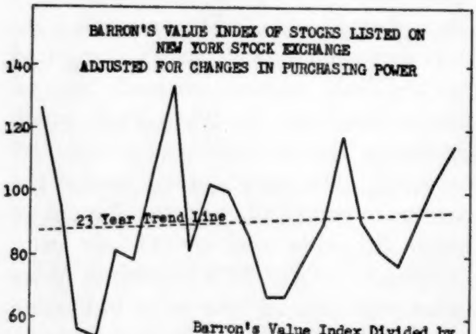
Between December 31, 1940, and December 31, 1951, Barron's value index (actually a price index computed by the link relative method) for all stocks listed on the New York Stock Exchange showed an increase of 149 per cent. During this same period the consumer price index of the Bureau of Labor Statistics rose by 85 per cent. (Changes in the BLS consumer price index will be used here as an indication of the inflationary or deflationary component in capital assets. However, it is

* The author is a member of the Department of Research and Statistics of the New York Stock Exchange.

[1] For a discussion of this aspect of the problem, see E. Cary Brown, "Tax Allowances for Depreciation Based on Changes in the Price Level," *National Tax Journal*, I (December, 1948), pp. 311-321.

fully realized that many arguments could be made in favor of using an index of wholesale prices or, quite possibly, that no existing price index would meet the requirements for adjusting asset values.) The selection of other dates would, of course, have shown a greater increase for consumer prices than for security prices. For purposes of this exposition, however, it is sufficient to state that over the past 15 years there has been a distinct upward trend in both security prices and consumer goods prices, the similarity between the two series being challenged primarily by the greater amplitude of fluctuation on the part of security prices. The fairly long-term relationship is illustrated in Chart I, which shows Barron's stock index on an adjusted basis (Barron's index divided by the BLS consumer price index), along with a trend line fitted by the least squares method.

CHART I



The period chosen naturally affects the fitted trend line, but these years, 1929-1951, do encompass several business cycles that are approximately complete. Most significant is the fact that the annual price increment along the trend line has been virtually nil over the past 23 years. To the investor this means that if he had made regular purchases over a period of time, and thereby averaged his prices so as to approximate the trend line, he would, in the event a gradual liquidation procedure were employed, experience dollar gains (the terms " dollar gain " and " dollar loss " will be used to refer to the difference between the uncorrected purchase price and the actual sale price of capital assets) that kept the purchasing power of his total investment approximately intact. That is, his investment holdings would show no *real* appreciation or *real* depreciation in terms of the composite of items included in the BLS consumer price index.

The presence of an inflationary component having been established, it is now incumbent to credit other components which, acting as a sum total effect, explain the level of security prices at particular times. In the case of common stocks, these include dividends, retention of earnings, increased productivity and efficiency, changed outlook for the industry as well as the particular company involved, and many intangible factors. These components (i.e., those other than the changing price level) may quite likely result in substantial gains or losses in terms of *real* purchasing power. Of the many influences that underlie the value of securities in general, however, probably none can claim greater effectiveness over longer periods of time than the price level for all goods and services.

The topic at hand is concerned with singling out, particularly for tax purposes, real or purchasing power gains and losses as opposed to shifts in value

that are merely associated with a changing price level. The problem applies to both upward and downward shifts in the general price level; the historical tendency has been toward inflation, however, and under present tax laws loss offsets are subject to limitation.

At the outset it should be mentioned that an investment can be retained *in toto* so long as it is not sold. In tax terminology a gain is "realized," and therefore becomes taxable, only at the time a sale or an exchange legally equivalent to a sale takes place.

Price Correction Technique

The adjustment of capital gains for changes in the general price level need not be complicated. For any given tax year a set of "correction factors" can easily be computed by dividing the average price index number for that year by the corresponding average for each preceding year. For example, the consumer price index for 1951, 185.6, divided by the 1945 index of 128.6 would give a correction factor of 1.44 for 1945 purchases which were sold in 1951. The net cost figure could then be multiplied by the correction factor applicable for the year in which the purchase had been made. The difference between the adjusted cost and the sale price would then show the price-corrected capital gain (loss) roughly in terms of current year dollars. The price-corrected gain (loss) would then be subject to whatever tax treatment was being accorded capital gains (losses) during the year the gain (loss) was "realized." Price correction factors, applicable to sales made during 1951, are shown in Table 1.

As an example, let us take a married man with two dependent children, receiving $7,500 per year in ordinary income. And let us say that he invested, in the year of his purchase, $10,000 in security X and sold these same shares in 1951 for $20,000. Neglecting expenses incident to the purchase and sale of the stock, but assuming income splitting, the 10 per cent standard deduction, and 1951 tax rates, our investor would have paid a total tax of $2,009.00, of which $1,114.60 would represent the additional liability resulting from the capital gain of $10,000. Without the gain his tax would have been $894.40. Under present tax laws this additional tax liability of $1,114.60, resulting from the gain, would be incurred irrespective of the year of purchase and the amount of price inflation (deflation) which had meanwhile ensued.

Under the price correction technique, the amount of taxable gain would hinge upon the degree of change in the general price level since the year of purchase. If $10,000 had been invested in 1945, the 1951 adjusted cost would be $14,400 ($10,000 times 1.44, the price correction factor for 1945). Deducting $14,400 from the $20,000 proceeds would leave a price-corrected gain of $5,600. Adding $2,800 to our investor's ordinary income to provide for 50 per cent or long-term inclusion, the additional tax resulting from the capital gain would now amount to $571.20 rather than the $1,114.60 added liability under the present system. Had the purchase been made during the depression year 1935, the rise in consumer prices (89 per cent) would reduce the

taxable gain sufficiently for our investor to incur a tax liability of only $110.88 under the price correction method.

Besides showing the additional tax caused by realization of the $10,000 gain, the last two columns of Table 1 show the amount of real gain (in 1951 dollars) after taxes if the purchase had been made during any of the given years. Under both the present system of tax treatment and the price correction method, *real* gains (in 1951 dollars) are greatly reduced through price inflation; however, the amount of net gain (after taxes) is diminished less under the latter. Since the present system taxes dollar gains as well as real gains, the net proceeds after taxes will be reduced below the original purchasing power of the investment if our hypothetical investor has purchased in a year having a correction factor of 1.89 or more. Thus, if the security were purchased in 1935, the additional tax resulting from the gain, $1,114.60, would exceed the price corrected capital gain of $1,100, leaving a net purchasing power loss of $14.60 after taxes. (See Table 1.) The point at which present taxes convert a real gain into a real loss varies, of course, according to the income position of the individual, but the principle remains the same. High income investors using the alternative rate of 25 per cent for long term gains would face a real capital loss, despite the $10,000 gain, if the price level had risen more than 75 per cent since the year of purchase.

TABLE 1

Illustration of Suggested Tax Treatment of Capital Gains and Losses

	Additional Tax Incurred by Hypothetical Investor as a Result of Realizing a $10,000 Capital Gain During 1951				Net Real Gain After Tax 1951 Tax Law	
Year of Purchase	Price Correction Factor	Price Corrected Cost	Price Corrected Gain	Additional Tax With Price Correction	Without Price Correction	With Price Correction
1950	1.08	$10,800	$9,200	$1,006.60	$8,085.40	$8,193.40
1945	1.44	14,400	5,600	571.20	4,485.40	5,028.80
1940	1.85	18,500	1.500	151.20	385.40	1,348.80
1935	1.89	18,900	1,100	110.88	- 14.60	989.12
1930	1.55	15,500	4,500	453.60	3,385.40	4,046.40
1925	1.48	14,800	5,200	526.40	4,085.40	4,673.60
1920	1.30	13,000	7,000	728.00	5,885.40	6,272.00

Assumptions:

1. Capital gain is adjusted for price correction.
2. Investor is married and has two dependent children.
3. Investor has ordinary income of $7,500.
4. Investor takes advantage of income-splitting.
5. Investor takes 10 per cent standard deduction up to $1,000.
6. Gain is accorded long term treatment.

If the price correction method were applied to a sale made during a depression year of the thirties, while the year of purchase had been the late twenties, the reverse situation would apply, but within limits. A decline in the general price level from the year of purchase would produce a correction factor of less than 1.00 and thereby reduce, for

tax purposes, the amount of loss available for offset purposes. Judging from historical relationships, however, the reduction in loss would probably be small because the general price level tends to fall relatively little as compared with security prices. Also, if limitations on loss offset against ordinary income continue to be retained in the tax structure, the net effect in such instances would be minor. This point will be touched upon again in a later section.

The procedure just described has the advantage of administrative simplicity. A list of the correction factors for any given tax year could be computed in a matter of minutes from whatever index might be chosen for adjustment purposes. If put into effect, it could conceivably be superimposed upon any existing tax structure for capital gains. Inclusion in present tax forms should involve relatively few complications.

Effects When Gains Predominate

A thorough analysis of any tax proposal is handicapped by the multiplicity of situations which can arise. The variables necessary to determine the effect on a particular investor would include his income bracket, number of dependents, the degree to which losses and gains occurred during the same tax year, loss carry-overs, the extent of general price change between the year of purchase and year of sale for each asset which involved a realized gain or loss, and many others. Even more complicated is the determination of the average or weighted effect on investors in the aggregate. Recourse will therefore be made to techniques of analysis similar to those described by Harold M. Somers in his article entitled "An Economic Analysis of the Capital Gains Tax"[2] in order to explain some of the more important effects of price correction when applied to capital assets. In the light of the analysis which has already been made, the comments to follow will, in so far as possible, be confined to the process whereby gains and losses are adjusted for changes in the general price level.

Beginning first with the situation where gains predominate, we note in Chart II that imposition of the capital gains tax causes an initial shift of the supply curve from SS to S′S′, HT being the amount of average tax liability. For a given price, OP, the number of shares offered would shrink from OA to OD. Chart II illustrates, therefore, that a tax on realized gains will increase the prices at which various quantities of shares are offered for sale. Using the price correction method, however, we find that the upward shift of the supply curve is reversed, from S′S′ to S″S″, as a result of not taxing the inflationary portion of the gain. The distance between S′S′ and S″S″, HR, would depend upon the years of purchase or, specifically, the degree of change in the general price level that had occurred between the years of purchase and the year of sale.

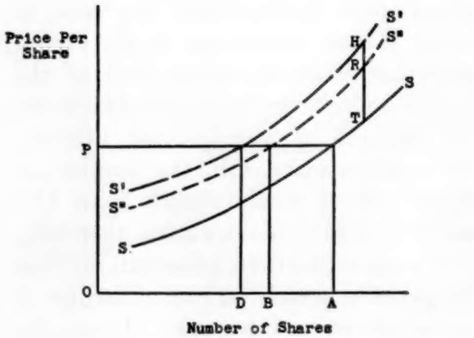
In practice, the distance HR would be a weighted average of the reduction in tax liability (due to price correction) for all share-owners who might be considered potential sellers. In so far as realized gains are explained by changes in the price level, the distance HR would be large, RT would be small and S″S″ would approach SS, the supply curve that would prevail in the absence of a tax on gains. The down-

[2] *National Tax Journal,* I (September, 1948), pp. 226-232.

ward shift of the supply curve to S″S″ would increase the number of shares offered at our given price, OP, from OD to OB. DB would therefore approach DA to the extent that gains approximated the rise in the general price level.

CHART II

SUPPLY CURVE FOR SECURITIES WHEN GAINS PREDOMINATE

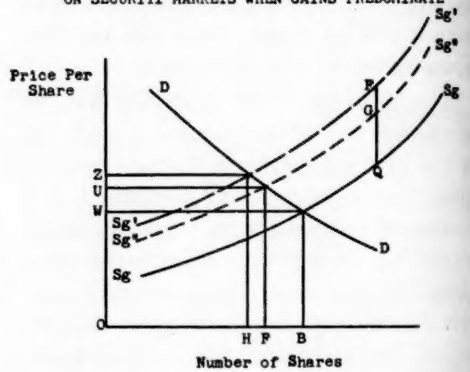


Using the same complex of supply curves but injecting a demand curve, we now observe the effects upon both price and quantity in Chart III. Looking first at the intersection of supply and demand as they would occur in the absence of a capital gains tax, we see that OB shares would be offered at price OW. This is indicated by the intersection of DD and SgSg. The imposition of the gains tax would lift the supply curve to Sg′Sg′, reduce the quantity to OH, and raise the price to OZ. The introduction of the price correction technique, assuming that some portion of the gains is associated with price inflation, will mitigate the effect of the tax by producing a new supply curve Sg″Sg″. In Chart III, Sg″Sg″ will cause a shift in the equilibrium point so that quantity increases from OH to OF and price decreases from OZ to OU.

Under the price correction method which reduces taxes on inflated dollar gains, we find, therefore, that at least a portion of the effects of a capital gains tax will be diminished. In other words, both the constriction on supply and the upward pressure on price will be less. Applying this to the security markets,

CHART III

EFFECT OF CAPITAL GAINS TAX AND PRICE CORRECTION ON SECURITY MARKETS WHEN GAINS PREDOMINATE



we find that the correction of asset values for general price changes would have a broadening as well as stabilizing influence. Recalling also that over longer periods of time a fairly close trend relationship has been maintained between stocks and the general price level, it is quite likely that the above influences could assume substantial proportions.

Repercussions on demand from superimposing, first, a capital gains tax and, second, price correction for inflationary gains are omitted from the diagram in order to avoid cluttering. Furthermore, the effect on demand is more difficult to ascertain because the future components making up any anticipated gains are frequently vague and resist segregation. It is also a fact that treatment of capital gains may be entirely different by the time an investment is sold, whereas a fairly close estimate can be made of the amount of tax

liability a seller will incur during a given year. At any rate, the existence of a capital gains tax tends to reduce the attractiveness and the anticipated return on capital assets. If shown on the diagram, the demand curve would shift downward as a result of the tax, but the use of a price correction technique would reduce this tendency to the extent that investors anticipated a rise in the general price level. Market volume, which suffers from a drop in demand when gains are taxable, would receive a positive stimulation from the knowledge that inflationary gains, when realized, would not incur a tax liability.

By way of concluding the analysis of effects during periods when gains predominate, it can be stated that the resulting shifts in both supply and demand due to the adjustment for change in price level will tend to increase market volume. And, considering the degree of tax consciousness prevalent today, the relaxation of this restraint could easily act as an important stabilizing influence on organized markets. Less certain is the effect on price, but if it is allowed that tax treatment is a more potent factor in the decision to sell (when selling it can be accurately measured), then a small downward and stabilizing influence on price would likely prevail.

Effects When Losses Predominate

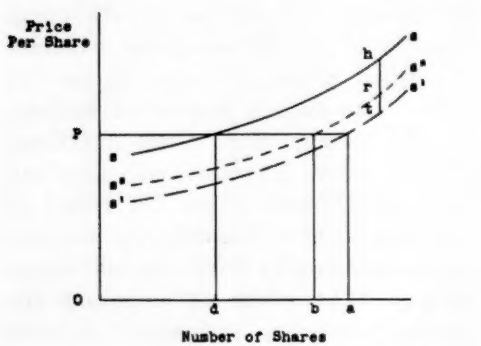
Turning now to the situation where losses predominate, we note a cause and effect relationship in reverse, with the important exception that under present tax laws the offset of losses is subject to limitation. While losses may be canceled against gains without restriction, the offset against ordinary income is presently limited to $1,000 annually, along with a carry-over provision. The significance of this limitation becomes more pronounced when viewed from an historical standpoint since the presence of cyclical fluctuations tends to produce a predominance of either gains or losses for individual years.

Though shifts will occur in supply and demand as a consequence of imposing first a capital gains tax and then price correction, for reasons cited above the shifts will usually be less than when gains predominate. Chart IV shows the downward shift of the supply curve from ss to s′s′ following the inclusion of capital gains and losses in the tax laws. The shift is downward because, to the extent that offset privileges (which reduce an individual's total tax bill) are allowed, sellers can afford to take less without reducing the net proceeds they receive from the sale transaction. The effect of imposing the price correction technique depends upon the direction of the general price level since the assets were purchased. If the price level had risen, then the loss would be greater in terms of current year dollars, and the enhanced offset figure would induce the seller to accept an even lower price than indicated by s′s′. Taking now the situation where prices had softened in the year that losses predominate, we note, as shown in Chart IV, that the loss in current dollars would be smaller, for offset purposes, thus making sales less attractive. Price correction would therefore cause the supply curve, s′s′, to shift upward to s″s″. Tracing the effects on quantity at a selected price OP, we see that the relief afforded by the initial provision for the offsetting of losses caused quantity to increase from Od to Oa. With an average price correction factor of less

than 1.00 (reflecting a lower price level), the loss would become less when converted into current dollars. The quantity Oa would thus decline to Ob. Had the average correction factor exceeded 1.00, the curve s″s″ would have dropped below s′s′ and the quantity of shares offered at price OP would have exceeded Oa.

CHART IV

SUPPLY CURVE FOR SECURITIES WHEN LOSSES PREDOMINATE

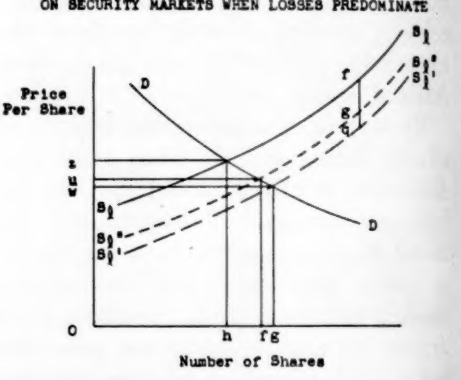


Adding the demand side in Chart V, we observe that price correction (assuming the majority of assets have experienced a lower general price level) simply mitigates the effect of including capital gains in the tax laws. With no tax treatment, equilibrium would occur at a price of Oz and quantity Oh. The inclusion of capital gains and losses in the tax structure would cause a reduction in price to Ow and an increase in quantity to Og (indicated by the crossing of DD and $S_1'S_1'$), but the imposition of price correction would reverse this tendency in accordance with the intersection of DD and $S_1''S_1''$. Once again it should be pointed out that the limitation on loss offset will probably minimize any influences that may develop when losses predominate.

Turning now to the demand curve, an important difference is noted in that assets are seldom purchased with the expectation of a loss. The imposition of a gains tax and also price correction would induce little change irrespective of whether losses or gains predominated during the year that an investment was purchased.

CHART V

EFFECT OF CAPITAL GAINS TAX AND PRICE CORRECTION ON SECURITY MARKETS WHEN LOSSES PREDOMINATE



In the two major illustrations, when gains predominate and when losses predominate (see Charts III and V), both the dollar gains and the dollar losses were reduced as a result of applying the price correction factor. It should be pointed out that this is not a discrepancy but a reflection of the fact that, in the illustrations selected, periods when gains predominate were associated with an inflationary price level, while a predominance of losses was associated with general price deflation.

General Implications

Summarizing the analysis to this point, we note that the taxation of capital gains and losses accentuates price fluctuations of assets subject to this tax. Also, when gains predominate, the tax

has a depressive effect on volume; but when losses predominate, quantity tends to increase, though in this case the effect is less pronounced. With the introduction of the price correction technique, however, each of the above influences is reduced to the degree that capital gains are associated with general inflation and losses are associated with deflation, in the aggregate.

Thus, illustrations of the preceding sections were based on the historically valid assumption that periods of gain tend to be associated with rising prices and that capital losses are apt to be associated with a decline in the general price level. Different assumptions with respect to the relationship between the price level and capital gains and losses, though less probable, should not create any particular hardship if the price correction technique is employed. If investors made capital gains in the face of a falling price level, their ability to pay would be increased along with their real gain. Should inflation and capital losses become associated, the real loss exceeds the dollar loss; however, relatively less relief is afforded even with price correction because of the limitation on loss offsets. All in all, the tax would fall more upon real, i.e., purchasing power, gains.

Turning to the mechanism of the market itself, it should be apparent that the price correction of gains and losses represents a move toward the classic concept of free market operations. Certainly the positive effects upon volume and mobility should be classed as elements which improve the market function.

In addition to the theoretical analysis that has been accorded the price correction method, a few comments should be included concerning the position of investment holdings at the present time. Particular reference is made to equity investments which contain large amounts of " unrealized " gains as a result of the doubling of the general price level during the past decade. There is little incentive to sell these investments and thereby incur a tax liability on inflationary as well as real gains. The present tax system therefore operates to freeze investments which show accrued gains. Investors understandingly take every opportunity to avoid tax liability on (dollar) gains which do not represent ability to pay. (See Chart I.) Finally, it should be unnecessary to point out that unrealized gains produce no revenue for federal or state governments.

With respect to the over-all employment of capital resources, it should be recalled that capital, along with any other factor of production, theoretically will be used to maximum advantage when anticipated returns from the last dollar invested in all enterprises are equalized. Failing this, a realignment of resources in keeping with this objective would expand the output of goods and services. The tax on capital gains is an impediment to the mobility and therefore the effective use of capital primarily because the levy is made not at the gain occurs but only at the time of sale. The tax further has the effect of reducing the mobility of capital which has been used most successfully.

(See Chart III.) This statement can be countered, of course, by saying that the tax encourages the sale of or shift from unsuccessful ventures. (See Chart V.) However, it is debatable whether a tax should have the effect of encouraging unsuccessful investors to sell out and perhaps try again while, at the same time, successful investors are immobilized and discouraged from shifting to new or different enterprises.

It is not the intent of this article to repeat pro and con arguments surrounding the capital gains tax, but to point out how the segregation of real gains, for tax purposes, can eliminate some of the disadvantages of this tax. For instance, neutralizing inflationary gains with respect to tax liability would improve investment mobility, thereby encouraging the more productive and profitable use of capital resources. Incidentally, the more productive use of capital would probably provide greater tax revenue inasmuch as the higher rate of return would be subject to ordinary income rates.

The revenue effects of adopting a price correction technique for capital gains and losses are difficult to ascertain. Speculation on the possible results should, however, be divided into the short and long term periods. In the short run we could expect considerable selling of assets purchased during and before the persistent upward rise in the general price level over the past decade. The initial " unfreezing " could well be sufficiently large to produce revenue in excess of payments now being made. Thus long delayed shifts and realignments of resources would probably be numerous.

Long term effects upon tax revenue would depend upon the degree of inflation or deflation that may occur in the future. If prices in general continue to rise, then the immobility introduced by the present capital gains treatment would be alleviated. In so far as inflationary gains would not constitute a tax liability, a significant cause of investment freezing would be removed as a consequence of introducing price correction. Thus, other things being equal, the average annual rate at which gains are " realized " should increase irrespective of rises that may occur in the general price level. Moreover, if the accelerated rate of realization outweighs the neutralization of inflationary gains, then the effect upon tax revenue would be positive. Quite possibly the greatest impetus to shorten the period before realization is the fact that the tax would become associated with *real* ability to pay.

Conclusions

1. The principle of adjusting for changes in the price level is not new. It has been employed in wage agreements, building contracts, etc. for many years. However, the proposal contained in this article is new in so far as tax practice in the United States is concerned.

2. If this principle were applied to gains and losses derived from equity investments, the taxation of capital gains would be based upon *real* changes in capital valuation and, therefore, *real* ability to pay. Under present legislation capital gains, even when reflecting nothing further than a rising price level, are nevertheless subject to full tax treatment.

3. The introduction of price correction for capital gains would mitigate the effects of the tax in so far as an inflationary situation prevailed between the time that equity investments, on the average, were purchased and sold. Assuming the presence of an inflationary component in capital gains, therefore, price correction would have a stabilizing effect on the price of equity assets, broaden market activity, and generally improve the functional contribution of investment markets. In other words, the purchase and sale of capital assets would more closely approximate the concept of free market operations.

4. Should capital losses predominate, the price correction technique retains its validity except that the effects would be materially reduced by present tax laws which limit the offset of losses against ordinary income. Assuming a predominance of losses and a declining price level, the tendency injected by price correction would be to retard the fall of equity values and diminish the supply of capital assests.

5. The most significant effect of price correction might well be the freeing of so-called "locked-in" investments. Freed from the tax on inflationary gains, considerable selling and shifting of investments could readily take place. And the resulting reallocation of resources would likely be toward the more efficient use of investment capital.

6. Finally, the adjustment of asset values in keeping with changes in the general price level should be looked upon as a method whereby more equitable treatment would be accorded one particular source of gain. In no sense does it constitute an argument for or against the inclusion of capital gains and losses *per se* in the income tax laws. Rather, the value of this proposal lies in the encouragement it offers to risk capital during a period of broad economic expansion.

NEW YORK CITY'S FINANCIAL SITUATION AND THE TRANSIT FARE

CARL S. SHOUP *

THIS ARTICLE was originally prepared as an address to the Women's City Club of New York on the finances of New York City, with particular reference to the transit fare problem. It discusses in some detail the recommendations made on transit fares by Professor Robert Murray Haig and myself, as directors of the Finance Project of the Management Survey.[1]

* The author is professor at the School of Business of Columbia University.

[1] The City of New York has sponsored and financed a number of research projects, under the Mayor's Committee on Management Survey, to recommend methods for increasing the efficiency of the city government and for raising additional revenue or improving the existing revenue system. The chairman of the committee is Lazarus Joseph, Comptroller; the executive director is Luther Gulick. The Finance Project was started in June, 1950, and concluded in June, 1952. Lyle C. Fitch was chief of staff in charge of research for this project. The main volume resulting from the project is entitled *The Financial Problem of the City of New York* (551 pp.); requests for copies should be sent to Dr. Luther Gulick, Mayor's Committee on Management Survey, 250 Church Street, New York 13, New York. Twelve other reports by the Finance Project, some of them not available for distribution, are listed at the back of the main volume. The specific revenue recommendations of the project were issued November 1, 1951, in mimeograph form; they are repeated in the main volume.

First, let us look at the City's financial situation as a whole. As we all know, it is one that calls for action. Even if we assume no expansion in the level or the scope of City services beyond that planned for currently, we estimated in our November 1, 1951 report that the fiscal year, 1952-1953, would present a prospective gap of $165 million between revenue and expenditure. Under the most favorable conditions for the following years, namely, high employment but no rise in prices, the estimated gap diminishes but is still set at $93 million in 1955-1956. Events since that estimate was made show that we were by no means over-pessimistic. In the summary and explanation of the proposed program for balancing the City's budget for the coming year, prepared by the research staff of Lieutenant Governor Moore and published on March 18, the City's needs for new funds are set at $224.5 million. While this figure is not strictly comparable with the $165 million estimated as of last November, it is roughly so, and the magnitude of the change shows that we are dealing with a problem whose dimensions can grow very rapidly.

Moreover, if, in the years that lie ahead, economic conditions become more difficult for the City, as under inflation or depression, the 1953 gap may well increase rather than decrease. An annual gap of more than $300 million by 1955-1956 is not at all improbable if inflation takes hold again or if depression brings greatly increased welfare needs while revenues shrink. When I speak of a gap, I mean the difference between what the existing revenue system would yield and what the expenditures would be. In actual fact, of course, no such gap will be allowed to develop; expenditures will have to be cut below the levels estimated, or new revenue sources will have to be found.

We may expect that some part of the gap may indeed be covered by a reduction of expenditures through economies in operation made possible by the findings of the Management Survey. Our projections of expenditures on which the above gap figures are computed allowed nothing for such savings; this was because at the time we made our computations the Survey studies were not advanced to the point where firm estimates of savings could be supplied to us.

But even with the best use of the Survey findings, it is clear that the City has arrived at the point in time where it must make some major, and practically irrevocable, decisions on its revenue system. To oversimplify somewhat, but not greatly, we may say these decisions can be expressed in three questions.

First, shall the system of state aid be greatly expanded, so that the City's needs will be met chiefly by additional revenue from this source rather than by additional City taxes?

Second, so far as the City is to rely on its own tax sources, shall it put together a program of the best available bits and pieces, including increases in existing taxes and new miscellaneous taxes, or shall it instead turn to the one major revenue source that it has not been using—the income tax?

Third, shall the need for either state aid or additional taxes be greatly reduced by obtaining more revenue from the transit system, and, if so, how shall this increased revenue be obtained?

Greater Reliance on State Aid?

Our answer to the first question—shall the system of state aid be greatly expanded—is, in general, in the negative. To be sure, New York City does have valid claims for some additional aid from the state, notably in the financing of the municipal colleges and by the return to the City of some of the motor fuel tax paid by automobile owners who operate within the City. But these are relatively small amounts. If the City were to meet its prospective financial gaps largely by increased state aid, the whole state aid system would have to be expanded greatly, including the aid going to upstate localities. New York City does not, in our opinion, have a case for getting a large increase in state aid all by itself, that is to say, partly at the expense of upstate residents who would help pay the new state taxes that would have to be levied for the additional aid to New York City. Again, I emphasize that I am here referring to large increases in state aid to the City—increases on the order of $100 million, more or less. There is a good case for an increase of some $50 million or thereabouts.

A great expansion of the state aid system to all localities, with correspondingly lower local taxes than would

otherwise be imposed, is inadvisable unless equalization considerations demand it. And on equalization grounds alone, New York City does not have a strong case for leading a campaign for such a large expansion of state aid.

A City Income Tax?

To consider now the second question: in so far as the City is to rely on taxes of its own to meet the prospective gaps, shall it adopt a program of bits and pieces or turn to the income tax?

Much depends, of course, on what kind of bits and pieces are available. Our own view was that a diligent search should be made for such sources of additional revenue; and, if a respectable program could be devised, this should be the path to follow, rather than the introduction of a third level of income tax. As it turned out, we did discover just enough revenue measures that seemed acceptable to fill the gap—"acceptable," that is, by certain standards which we set up and explain in our forthcoming main report.[2] But it was a close thing. Had the gap been much larger we should have been forced to conclude that the City was bound to turn to the income tax. Moreover, among the revenue measures in this package that we assembled was an increase in average subway fare, a matter to which I shall turn shortly.

The chief reason for not recommending a City income tax rather than the package of smaller revenue measures was one of administration and taxpayer reaction. Three levels of income tax would, we feared, increase tax consciousness to a pitch of unreasonable tax irritation. Moreover, administration of such a tax would call for a level of technical competence that cannot be considered assured at the moment. Perhaps a fragmentary income tax, like that imposed in Philadelphia, could be administered without great difficulty (though it must be noted that even there only two levels of personal income tax prevail), but we believe it would be unfair to impose a tax on salaries and wages and on unincorporated business profits without including in the tax base investment income such as dividends and interest.

Also, the advantages of the income tax in distributing the tax burden, even if it is a comprehensive income tax, were found upon study to be smaller than anticipated. The federal rates are so high that a City income tax cannot be imposed at substantial, effective progressive rates. If a progressive-rate tax were imposed, it would work out as almost a proportional tax in fact, since the taxpayer could deduct the City tax in computing his income subject to the federal tax. Federal tax receipts would thereby drop. In effect, a large part of the tax would be coming out of the federal government. While this result is not necessarily to be deplored if on a limited scale, it does threaten to raise problems of intergovernmental comity if the magnitudes involved become substantial.

Despite these reservations about the income tax, it remains a distinct possibility as a long-run solution to the City's fiscal problems. The amounts that it would yield are substantial. A

[2] *The Financial Problem of the City of New York*, Chapter XI, "Standards for Choice Among Revenue Measures." The topics considered in setting standards are: equity, benefit taxation and pricing, economic effects, tax consciousness, cycle sensitivity, administration, and intergovernmental relations.

2 per cent tax on incomes above exemptions of $624 per person would yield nearly $250 million; so would a graduated tax, with that exemption, at rates of 1 per cent on the first $2,000, 2 per cent on the next $2,000, and 3 per cent on the remainder. Such a tax would not only fill the prospective gaps (except under the more unfavorable assumptions), but would allow for reduction or repeal of some of the existing taxes, more particularly the general business and financial tax or the retail sales tax.

If the City were willing to grant the higher personal exemption given by the state, some arrangement with the state might be worked out whereby the City tax would be simply a supplement to the state tax, computed on the state income tax return and administered by state officials.

There are other considerations, too, which must be kept in mind, including the sensitivity of an income tax to fluctuations in business conditions, but I shall not attempt to list them here. In any event, the real estate tax will remain by far the biggest tax in the City's system.

Before passing on to the third question, the subway fare problem, I shall list the tax and state-aid program that we recommended on November 1, 1951, and compare it with the stopgap program recently proposed and partly enacted. The comparison is of limited interest since the stopgap program contains some measures, like the advancing of the date of payment of the sales tax, that by their nature can be used only once and will not be available again for 1953-1954, whereas our program may be used for an indefinite period.

We recommended:

1. A prompt increase in real estate assessments to full value to yield $6 million in 1952-1953 and $25 million by 1956. Some types of property, notably one- and two-family houses and new construction, are being assessed at well below market value. The stopgap program does not include this measure, at least not explicitly.

2. Increased use of local area special assessments, to yield $3 million next year and $15 million by 1956. The stopgap program does not include this measure.

3. Inclusion of cigarettes and beer under the sales tax. At present they are exempt from the sales tax. This would yield $15 million. The stopgap program authorizes the city to impose a somewhat larger tax of 1 cent a pack on cigarettes.

4. An increase in the rate of the hotel room tax (now 5 per cent) to 10 per cent to yield $5 million. This is not a part of the stopgap program.

5. Improved administration of the sales tax and general business and financial tax, largely by employing more auditors, to yield about $10 million a year. In the stopgap program as proposed in Albany, only $1 million was entered on this score. (It was noted by the state authorities that the City officials said they could not get even this much.)

6. Extend use of parking meters and impose a monthly charge of $5 for overnight parking in certain areas of the City. Total net yield, $15 million. The monthly charge is not included in the stopgap program.

7. The state to give to the City a share in the state motor fuel tax amounting to $25 million a year. This is not in the stopgap program.

8. The state to assume the cost of operating the City colleges, amounting to about $14 million. This is not a part of the stopgap program.

9. To give the City a safety margin in the event of inflation, amend the constitution to raise the limit on the real estate tax rate to 3 per cent. Actually, it might not be necessary under our program to use any,

or more than a small part, of this increase. However, we anticipate that in any event there will be some small increase in the rate outside the limit (though we did not contemplate a three-year $100 million bond issue for transit deficits). The stopgap program calls for an amendment raising the limit to 2½ per cent.

On the other hand, there are four elements in the stopgap program that are not in our recommendations:

(1) An auto use tax of $5 and $10 a year, and

(2) A 25 per cent surcharge on state retail liquor license fees.

These would yield $8 million and $3½ million a year respectively, but by hurrying them into effect the stopgap program calls for collecting two years' taxes in one, thus obtaining $23 million by June 30, 1953.

(3) An increase, with a certain amount of offsetting relief, in the rate of the tax on gross income of so-called financial businesses from 4 tenths of 1 per cent to 8 tenths of 1 per cent, to yield $2 million.

(4) A 15 per cent tax on admissions to race tracks to yield $700,000.

It was noted by the state authorities that an admissions tax and inclusion of beer in the sales tax were measures which the City is already empowered to take but which are opposed by the City authorities.

In summary, the stopgap program, in its tax measures and in its lack of state-aid measures, bears only slight resemblance to our recommendations for permanent additions. But, as noted, comparison is scarcely possible; the stopgap program includes, according to an unofficial estimate published March 18, 1952, a total of about $50 million nonrecurring revenues.

More Revenue from Transit System?

We come now to the third question, shall the need for either state aid or additional City taxes be greatly reduced by obtaining more revenue from the transit system? Let us look at the magnitude involved.

The operating deficits on the subway under the 10 cent fare, accumulated deficit and prospective deficits, are so large that they send repercussions through the entire financial system of the City.

The deficits accumulated by June 30, 1952, amounted to roughly $33 million. The deficit for the year ending June 30, 1953, is estimated at roughly $68 million (including $13.5 million of pension system contributions).

Under the stopgap program for carrying the City over the coming fiscal year, this huge operating deficit, totaling $100 million, in effect will be met by an increase in the real estate tax over the next four years. Bonds will be issued, some in 1952 and some in 1953, to meet the deficit, and these bonds must be retired within three years. That part of the real estate tax that is outside the present 2 per cent constitutional debt limit will be increased to pay the interest on and provide for the amortization of these bonds. As late as 1956, real estate taxpayers will be paying for a transit deficit incurred in 1952-1953.

Meanwhile, the first steps have been taken to amend the state constitution to raise the limit on the real estate tax to 2½ per cent. Surely it is not expected that bonds will continue to be issued for the indefinite future to fund

transit deficits, bonds that must be retired by an increase in the real estate tax, if at the same time it is anticipated that the real estate tax will be raised to $2\frac{1}{2}$ per cent for outlays other than debt service. If a transit debt of \$68 million a year were to be financed regularly by an increase in the real estate tax, that increase would be nearly 4 mills on the present base.

Evidently there is a general expectation that something will be done about the subway deficit before another year rolls around. But what?

One possibility is to keep the flat fare system, but raise the fare to 15 cents. This would produce perhaps \$50 million of added subway revenue, and so would still fall short of meeting a deficit of \$68 million a year. But the disadvantages of a flat fare of 15 cents are so great, for reasons given below, that we concluded that some system of varying the fare according to time of day and distance traveled had to be designed. A system that we believe is workable has been devised and it would yield about \$40 million of added revenue. It would be extremely difficult to go beyond this amount without incurring grave disadvantages.

In approaching the subway fare problem, we kept in mind one very important consideration: New York City has an extensive subway system, one that cost a great deal of money to build, and the City should make the best possible use of that system. It should not waste any more of it than is necessary. In particular, the City should not set a fare that would make a large part of the system go to waste because it would drive people off the subway at times when it is already underutilized; this is the case during nonrush hours in many places, and in counterrush direction of travel during rush hour. Similarly, and here is the sticking point for many who would otherwise agree, it is necessary to discourage rush hour travel just as far as our standards of justice allow us.

If the subway fare is raised to a flat 15 cents, for example, there will be a considerable falling off of traffic in the nonrush hours and in nonrush directions. Space in cars and trackage that is already greatly underutilized will be wasted still further. There will also be some drop in rush hour traffic, but not a great deal on a 5-cent increase; some of the people who do not truly need to travel in rush hours will still do so. We must remember that travel in the rush hour is not too uncomfortable for someone who gets on far enough out to obtain a seat; but his presence increases the crowding of those who get on later. Experience with the rise in fare from 5 cents to 10 cents shows that a fare increase does cause a permanent decrease in rush-hour traffic.

The following plan, which, by the way, was badly misrepresented in the press some months ago owing to an unauthorized and biased release of only part of the plan, is aimed at these five objectives: (1) getting substantial additional revenue from the subway system—about \$40 million a year, which is almost as much as could be obtained from a flat 15-cent fare; (2) increasing the use of the subway system in off hours and counterrush directions, compared with what would happen under a flat 15-cent fare; (3) decreasing the use of the subway in rush hours in rush

directions, compared with what would happen under a 15-cent fare; (4) keeping the fare lower than 15 cents for many of the truly low-income workers (charwomen, night-watchmen and those with similar types of jobs calling for irregular or night work); (5) keeping the fare about as low for many *families* of low and moderate income status as it would be under a flat 15-cent fare. On this last point, we must recall that what really counts, in weighing the burden of the subway fare, is the annual total fare paid by all members of one economic unit, the family. If the working member of the family pays a higher fare, but the shopping member pays a lower fare, and if weekend excursions with the children can be taken at a lower fare, then for the family as a whole the burden of the subway fare may be no greater than before. Still, there will be some individuals and families who would suffer under the plan proposed here, compared with what they would experience under a flat 15-cent fare. Our position is that, on the whole, our plan is probably less of a burden on the very low income families as families, and at the same time it makes for a much better utilization of the subway system than would be found under a flat 15-cent fare.

The plan is based on two ideas, both familiar in many fields of pricing. First, the longer the ride the more the rider should pay. Second, he should pay less if he travels in off-hours and in counterrush directions than if he travels in rush hours in rush directions. It is this second idea which many of us are inclined to reject at first, but a little thought will show that we accept it without question with respect to several other consumer outlays. Moving picture theatres are crowded in the evening, compared with the morning; yet the patrons who go in the evening—who must go in the evening if they are to see the show at all—pay the higher price without, apparently, a sense of great injustice. Off-season low fares for travel by boats, airplanes, and railroads are not unknown, to say the least. But because we are not used to the idea with respect to the subway, we think of it as unjust. We look at it as a plan that makes rush-hour riders pay more, forgetting the other side of the coin; it might as well be described as a plan that makes the nonrush hour rider pay less.

The higher price for the rush-hour rider is not merely designed to discourage all but essential riders, thus lessening the congestion at those times. It is also designed to help finance the building of extensions, if they are necessary. If we do have to go ahead with the full plans for the Second Avenue subway, the cost will be large indeed, even in New York City terms. The need for this subway arises largely from the unbalanced traffic pattern, the extreme concentration in the rush hour.

Specifically: (1) Our zone-time plan proposes that the nickel fare be brought back for short rides at all times (even during rush hours) and for moderate length rides in nonrush hours and directions. Under this plan it seems likely that about one-fifth of the rides would be nickel rides. (2) It proposes that the 10-cent fare be retained for about one-third of the rides—and we must recall that no 10-cent fare at all can be retained if the subway deficit is to be reduced while keeping the flat-

fare principle. Thus, under the zone-time system about one-half the rides would be for 5 cents or 10 cents. (3) It proposes that a top fare of 25 cents be charged for a small proportion of the total rides, namely, for those rides that are over five miles in length and that also penetrate the downtown area in rush hours, moving in the rush direction. Probably not more than 10 per cent of total rides would cost 25 cents. (4) In between would be rides at 15 cents (which everyone will have to pay under the flat-fare system if another $50 million or so of revenue is to be obtained from transit fares) and 20 cents.

When we first considered how a zone-time system might be operated we studied what was being done elsewhere, especially in London which uses a zone fare (but with no time differential). Unfortunately, we received no substantial help from such studies. The London system makes such extensive use of manpower (and womanpower) as to be prohibitively expensive for New York City. Guards must be stationed at exits to take tickets from the passengers as they leave the subway. We concluded that only some mechanical system would be feasible, if indeed any system at all would be feasible.

After considerable study, William S. Vickrey developed for the project a mechanical plan that is practicable. However, we have no wish to be dogmatic on this score; certainly it should not be adopted without further intensive study by transit engineers. At least, we believe it is sufficiently promising to deserve such consideration. And let us remind ourselves that we gain nothing by a basically unsympathetic approach to such a zone-time plan. If a mechanical plan of this or some other type cannot be made to work, we shall be in a difficult situation indeed. We shall then be able to use only a flat fare, and the alternatives under the flat fare will be two, both unpalatable. First, the fare can be kept at 10 cents and the large annual operating deficit made up by extra taxation. This in turn will surely mean the city will supply less education, less police service, less fire protection, as it uses up some of its limited taxing resources to meet the large and growing subway deficit. I do not mean there will be a dollar for dollar reduction, but simply that financing a large subway deficit by taxation will surely, to some degree, restrict the financing of other city services. The other alternative will be to raise the flat fare to 15 cents or even more. The uncrowded parts of the subway system will go still more to waste through nonuse; the crowded rush-hour trains will remain almost as crowded; new and costly subway extensions will have to be built that will in turn create new operating deficits, calling for a further rise in the flat rate fare. It is even conceivable that in the long run no flat rate fare can be found, no matter how high, that will make the subway self-supporting. As the flat fare goes up and up, it will eventually reach a point where it drives so many riders off at all hours that the system's gross revenues fall (as the fare rises) more rapidly than its expenses.

The time-zone plan would be operated by requiring every rider to deposit a 25-cent piece in the entrance

turnstile. He would receive, from a mechanical dispenser on the turnstile, a small notched metal tab or key which he would have to keep until he finished his ride, just as the Londoner must keep his ticket. (Anyone who lost his key would probably be let out with little or no extra charge, but without getting any of his quarter back.)

When he leaves the subway system through the exit turnstile, the rider must deposit the metal key in the turnstile mechanism. This mechanism would sense, by the notches on the key, where the rider had come from; the turnstile mechanism would be tied into a decoding apparatus controlled by a clock; and within a fraction of a second it would determine the proper fare and dispense to the rider the correct amount of change (if any) from his quarter. After the rider has picked up this change, the exit turnstile would let him through. For example, on a very short ride at any time, or on a somewhat longer ride at nonrush hours or in nonrush directions, the rider would pick up 20 cents in change upon leaving the system. The process of dropping a key in a slot and picking up the change would take very little time, and a sufficient number of exit turnstiles could readily be installed so that passengers would experience no appreciable delay in leaving stations. (There are alternative ways of handling this particular part of the exit problem, but I shall not go into detail here.) A detailed technical memorandum has been drawn up, specifying the exact nature of the electrical and mechanical system that would be required. The proposal is thus at the point where it may be seriously examined by engineers and others who are specialists in this field.

What of the cost of installing and operating such a system? We estimate that it would involve an additional annual cost of about $2½ million, including interest and amortization at 5 per cent on some $20 million of capital outlay for equipment and installation, including about 5,000 extra turnstiles.

Perhaps some much better system or some notable improvements on the present proposal can be devised; but unless they are found, and found soon, we urge adoption of the zone-time plan outlined above, in the absence of some decisive disadvantage not yet apparent.

The fact is, we New Yorkers are in a position where we just about have to find some way of making a zone-time system work. If we laugh it off as a silly idea or shrug it off as an impossible job and keep the fare at 10 cents, we are in for some unpleasant experiences in lower educational, police, fire, and other services. And if we keep on raising and raising the flat rate fare, we are in for both further waste and more crowding of a subway system that is already grappling with its alternating periods of strangulation and underutilization.

AN ECONOMIC LIMIT ON TAXES: SOME RECENT DISCUSSIONS

RICHARD GOODE *

THE IDEA that there is an economic limit to the taxable capacity of a country has long been a subject of speculation. Several eighteenth and nineteenth century writers agreed that taxes amounting to 15 per cent of the national income are excessive in all but the most exceptional circumstances.[1] Shortly after World War I Sir Josiah Stamp presented a systematic discussion of the concept of taxable capacity and the factors governing it.[2] His reasoning gave no support to the opinion that any one limit holds for all times and places; rather, he emphasized significant differences in the amount of revenue that can safely be raised. This approach has generally been followed in the extensive discussions of fiscal capacity in connection with equalizing grants-in-aid. The variability of political and administrative limitations on taxation has also received attention.

More recently Colin Clark, the well-known Australian economist, has put forward a new thesis regarding the economic limit of taxation. Clark notes that, according to the usual theory of fiscal policy, an important function of taxation is to prevent inflation. He argues, however, that in nontotalitarian countries in times of peace, taxation ceases to be effective in controlling inflation when it exceeds approximately 25 per cent of national income.[3] The 25 per cent figure is for all taxes—national, state, and local—regardless of form and applies to the ratio of total taxes to national income rather than to the effective rate on any one person's income or property or on any particular transaction. Clark's generalization, therefore, must be sharply distinguished from the proposal for a constitutional amendment limiting federal income taxes to 25 per cent.

The validity of Clark's thesis is of immediate practical importance in the United States inasmuch as taxes currently exceed one-fourth of national income and the country is faced with an inflation problem. Federal, state, and local tax liabilities are estimated at the following percentages of national income: [4]

* The author is a member of the staff of the International Monetary Fund. Opinions expressed in this note are his own and do not necessarily reflect the official views of the Fund.

[1] C. F. Bastable, *Public Finance* (3d ed.; London: Macmillan & Co., 1903), pp. 136-7.

[2] *Wealth and Taxable Capacity* (London: P. S. King & Son, 1930), Chapter IV. Hugh Dalton took a very skeptical view of the arguments advanced by Stamp and others, concluding that "absolute taxable capacity is a myth." (*Principles of Public Finance* [London: Routledge & Kegan Paul, 1948], pp. 163-71.)

[3] "Public Finance and Changes in the Value of Money," *Economic Journal*, LV (December, 1945), pp. 371-89; "The Danger Point in Taxes," *Harper's Magazine*, December, 1950, pp. 67-69.

[4] Report of the Joint Committee on the Economic Report and Materials Prepared by the Staff, 82d Cong., 2d sess. (Senate Report No. 1295, February, 1952), p. 41.

Calendar year 1939 ...	22.5 per cent
Calendar year 1944 ...	28.7 per cent
Fiscal year 1951	31.6 per cent

Recognizing the significance of the topic, the Joint Congressional Committee on the Economic Report included the subject in its hearings on the President's January, 1952, Economic Report and in its own Joint Economic Report.[5] The purpose of this note is to summarize the Clark thesis and these recent discussions. I shall not attempt an independent critical evaluation of the thesis or of the discussions.

Clark's Thesis

In his original article (*Economic Journal*, 1945) Clark emphasizes a quasi-political explanation of the tax limit. He argues that when taxation exceeds 25 per cent of national income, influential groups will favor inflation as a means of reducing the burden of the public debt and other fixed charges in the budget. After inflation has brought taxes below the critical level, these groups will favor stabilization. This article is open to the interpretation that the limit of taxation is simply the point beyond which democratic countries will refuse to tax themselves, except perhaps in wartime.

In his later article (*Harper's*, 1950), however, Clark makes it clear that he believes the anti-inflationary power of taxation is subject to a strict economic limit. He agrees with the common opinion that deficit spending is inflationary but adds that "if a government incurs very heavy expenditures, and these *are* covered by taxation, so that the budget is balanced, the trend—while it may be deflationary for a time—will in the long run be toward inflation if the rate of taxation is too high to be borne" (p. 67). The "long run" is defined as ordinarily a period of two or three years, although it may be longer in wartime.

Clark attributes the economic limit to three consequences of high taxation: (1) weakening of employers' normal resistance to wage increases; (2) wasteful business expenditures; and (3) a decrease in the amount and efficiency of work. He appears, however, to rest his case mainly on a statistical examination of the experience of a number of countries in the interwar years and in the period since World War II.

In comparison with earlier discussions of taxable capacity, Clark omits several points that have usually been considered important. (1) Apart from the broad recognition of a difference between totalitarian and nontotalitarian countries and between wartime and peacetime, Clark makes no allowance for variations in countries' political and administrative conditions. Apparently he considers political maturity, a tradition of voluntary compliance with tax laws, and a skilled administration of little fundamental significance in determining the extent to which taxes can be raised. (2) He also disregards the absolute size of the national income, applying the same limit to poor countries such as Italy and Japan and to rich countries such as the United States and New Zealand. The usual view is similar to that of Bastable who said, "Expenditure requiring 10 per cent. of the annual income of India would be much more burdensome than if 30 per cent. were to be required in England or

[5] *January 1952 Economic Report of the President*, Hearings before the Joint Committee on the Economic Report, 82d Cong., 2d sess., January-February, 1952; Report, *op. cit.*

the United States."[6] Clark does endorse the common belief that in a country where the distribution of income is comparatively equal, the limit of taxation is lower than in a country where inequality is greater, although he does not explain why this is so. (3) In the articles already cited, Clark gives no attention to the form of taxation or to the progressivity or regressivity of rates. A reader could reasonably infer that Clark believes that the same limit holds for a tax system composed exclusively of regressive consumption taxes and for a system relying solely on progressive taxes on income and profits. It seems, however, that only taxes on profits would stimulate wasteful business expenditures or weaken employers' resistance to wage increases. (4) Clark does not explore the relation between the yield of the tax system and the level of money income. It is generally recognized that if the system as a whole is progressive, revenues increase more than proportionately when money national income rises. It appears, therefore, that in many countries inflation, far from lightening the tax burden, would increase it unless tax rates were lowered. (5) Finally, aside from great stress on interest and service charges on the public debt, Clark takes no account of the purpose of government expenditures. Most writers believe that a sharp distinction must be made between transfer payments and expenditures for goods and services, and between expenditures that increase the stock of social capital and productive efficiency and those that do not.

[6] *Public Finance,* p. 137.

The foregoing characterization applies to the statements of the Clark thesis already cited. Since writing these articles, however, Clark seems to have modified his views to some extent. In January, 1952, Grover W. Ensley, staff director of the Joint Committee on the Economic Report, cabled Mr. Clark mentioning the practical problem of policy faced by the United States and asking whether he still believed that the 25 per cent limit held for this country. In a letter dated January 18, 1952, Clark replied: ". . . all the reasoning and conclusions of my article in Harpers magazine, to the best of my knowledge, still stand. No information which has become available since that date will effect any important alteration" (Hearings, p. 316). He went on to say that the 25 per cent is a round figure and that the limit should be stated as 24-26 per cent or even 23-27 per cent. He added a more significant concession by saying that if highly regressive taxes are adopted, it may be possible to go a " few points " beyond the 25 per cent limit without causing prices and incomes to rise. Inasmuch as Clark's letter is of considerable interest, the relevant passages are reprinted at the end of this note.

Joint Committee Discussions

The Joint Committee on the Economic Report included the Clark thesis on the agenda of a panel discussion held January 31, 1952, as part of its hearings on the President's Economic Report. Participants were Prof. Alfred G. Buehler, University of Pennsylvania; H. van Buren Cleveland, research staff

member, Committee for Economic Development; Prof. Milton Friedman, University of Chicago; Prof. Walter W. Heller, University of Minnesota; Prof. John P. Miller, Yale University; Prof. Richard A. Musgrave, University of Michigan; Prof. Carl S. Shoup, Columbia University; and Prof. Arthur Smithies, Harvard University.

Professor Heller took the lead in discussing the limit hypothesis (Hearings, pp. 315-25). He argues that Clark's statistical evidence does not support his proposition. For the postwar period Clark does not show that inflation was worse in countries where taxation exceeded 25 per cent of national income than it was in other countries. Heller attributes the general postwar inflation to deficit spending during the war, liquid asset accumulations, and postwar dislocations. He points out that in 1950 the price rise experienced by the United States increased the ratio of taxes to national income, allowing for rate changes. For the interwar period Heller contends that some of Clark's own data support the reverse of his limit thesis.[7]

Heller concludes that the statistical data do not establish the 25 per cent rule, but he goes on to examine the supporting arguments. He points out that taxation is inflationary only if it reduces total supply of goods and services more than it cuts aggregate demand. Heller then considers Clark's reasons for believing this may occur when tax rates are high. He doubts whether it can be shown that high taxes promote wasteful business expenditures. He asks if it is not equally plausible to assume that businessmen will carefully guard their limited profits and will be concerned about damaging their competitive position by letting their costs get out of line with those of other firms. He concedes that some " nest-feathering " outlays which will yield a return in the future may be stimulated if they can be written off against current income subject to high tax rates. Lowered resistance to wage increases, he believes, may reflect a labor shortage rather than high taxation. With regard to work incentives, Heller says that taxation may have adverse effects or may stimulate the individual to work more in order to reach his income " target," and that we do not know which response is more important.

In conclusion, Heller rejects the 25 per cent limit thesis but concedes that there is a limit on our ability to prevent inflation by taxation. He explains that government expenditures are inflationary under full-employment conditions and says that as expenditures rise it becomes increasingly difficult to counteract their inflationary effect. He believes that in the United States additional taxes are anti-inflationary far above 25 per cent of national income and, indeed, that there is no sudden change to inflation at any one point but rather a gradual deterioration of the anti-inflationary power of taxation. He considers marginal rates more significant than average rates and apparently feels that highly progressive taxes are least effective in controlling inflation.

[7] A more comprehensive review of Clark's statistics is contained in an article by Joseph A. Pechman and Thomas Mayer, published in the *Review of Economics and Statistics*, August, 1952.

Professor Musgrave commented briefly on the Clark thesis, saying that a 25 or 30 per cent upper limit on taxable capacity is an " imaginary notion " and that he believes the United States is nowhere near the limit of its taxable capacity (Hearings, pp. 311, 313).

In a few remarks on the limit idea, Professor Buehler expressed the opinion that taxable capacity varies with the national income, type of taxes, suddenness of tax increases, purposes of government expenditures, public attitudes, and other factors. Although he doubts that the Clark thesis can be substantiated with statistics, he suggests that the argument may have merit in the sense that at some point the government and the people would prefer inflation to higher taxes. He considers it an open question whether that point has been reached in the United States (Hearings, pp. 326-27).

At the end of the session, Senator Joseph C. O'Mahoney, chairman of the committee, said that he understood that the panel did not support the Clark theory of a 25 per cent limit on taxation. There was no dissent (Hearings, p. 358).

In its report the majority of the Joint Committee commented on the limit thesis as follows:

> There appears to be some upper economic limit to taxes, although not an inflexible percentage of the Nation's income, but an area beyond which further tax increases would aggravate inflation and reduce initiative and output. Some may believe that this limit has been reached.
>
> Much evidence was presented to the committee indicating that the United States has not yet reached the economic limit beyond which an increase in carefully distributed taxes would necessarily prove inflationary. The committee concurs with this view, although it is concerned both with the burdens already being borne by low-income families and with the adverse effects on incentives and deterrents to venture capital in the high-income brackets.[8]

The committee, nevertheless, opposed any general increases in tax rates, although it advocated elimination of inequities and tightening of administration (Report, p. 15).

The staff of the Joint Committee, in materials prepared to accompany the committee report, stresses the purpose of government expenditures as a factor determining taxable capacity. It points out that taxes to finance important services which are part of the standard of living are similar to fees or prices for services rendered and are not burdensome in the same sense as taxes to pay for defense expenditures (Report, pp. 82-83).

Points for Further Investigation

The Joint Committee on the Economic Report has rendered an important service in stimulating discussion of the extent to which inflation can be controlled by taxation. Witnesses before the committee, the majority of the committee, and the committee staff agreed in believing that the 25 per cent limit is not applicable in the United States at the present time. But they did not reject the idea that at some point taxation will cease to be anti-inflationary and may become positively inflationary. It is not the purpose of this note to appraise these judgments,

[8] Report, p. 8.

but I do want to suggest the desirability of further clarification of exactly how the limit is supposed to operate. A showing that excessive taxation has undesirable economic consequences does not prove that taxes are not anti-inflationary, although it may indicate that other means of controlling inflation or a limited degree of open inflation would be preferable to higher taxes. A careful theoretical statement of how the limit is supposed to operate, even if in purely abstract terms, might greatly assist in further inductive studies of the relation between taxation and inflation. If statistical studies are to shed much light on the subject, they should include factors such as the size of the deficit, the size and composition of the public debt, interest rates, changes in the money supply, and purposes of government expenditures as well as the ratio of taxation to national income. An international comparison of this type would encounter great statistical and conceptual difficulties, but it might help show whether the limit is already at hand or only a remote possibility.

LETTER OF COLIN CLARK [9]

Economic Services,
South Brisbane, January 18, 1952

Mr. Grover W. Ensley,
Staff Director, Joint Committee on the Economic Report,
Washington, United States of America.

Dear Mr. Ensley: In reply to your cable of January 9, I would advise that my proposition about the 25-percent limit was originally put forward in an article in Economic Journal, December 1945 (published in England) a copy of which is presumably available to you. The article in Harpers supplemented this and brought it up to date without printing the original information in full detail. I would say that all the reasoning and conclusions of my article in Harpers magazine, to the best of my knowledge, still stand. No information which has become available since that date will effect any important alteration.

There is, however, one point which I should like to emphasize further, and that is the undoubted effect of high marginal rates of income tax on businesses, encouraging them to spend money freely on all those fields of expenditure which are allowed as a deduction for income-tax purposes. To my mind it is significant that so careful and responsible a periodical as Fortune recently published an article by a highly qualified taxation counsel, advising businessmen how to spend what is called 18-cent dollars; i.e., that each dollar spent on maintenance and in certain other ways only made a difference of 18 cents to the firm's net profit after taxation.

It is true that the loss of 18 cents remains a loss of 18 cents, and no business will overmaintain or otherwise spend money on purely unnecessary objects, but when it is in doubt whether or not to spend, it will always be biased in the direction of spending of more rather than less. In many respects such as the payment of higher wages, salaries, and bonuses, the payments for advertisement, entertainments, and public relations, the business can obtain definite advantages for itself in the future at the expense of the United States Treasury in the present.

This now brings us to the question of whether there are any grounds for hope that the 25-percent limit could be safely exceeded, and if so, under what circumstances. As you will see from the original articles in Economic Journal and Harpers the 25 percent is a round figure rather than a precise

[9] *January 1952 Economic Report of the President*, Hearings before the Joint Committee on the Economic Report, 82d Cong., 2d sess., January-February, 1952; pp. 315-17.

limit and should certainly be written 24-26 if not 23-27. When, however, your figure is as high as 27 I should say myself, I would be willing to bet with a fairly high degree of probability on a further increase of money wages and consequent inflation to the national income as a whole.

If taxation of this order of magnitude appears unavoidable, you may then ask whether there is any form or forms of taxation least likely to cause an upward pressure on prices and incomes.

Under circumstances envisaged with an inescapable necessity of imposing taxation at a level of 27 percent or more, on national income, we can minimize the upward pressure by a system which, in general terms, keeps down marginal taxation with consequent necessary raising of average rates of taxation. Such a program, it need hardly be pointed out, would be extremely unpopular. It would mean removing, where possible, the progressive elements in the tax system, charging lower rates on the high incomes and higher rates on the low incomes, relying upon indirect rather than direct taxation, and making indirect taxation fall upon necessaries rather than upon amenities.

Recently I spent a month in Italy, followed by a short visit to Britain, and could not help being struck by the contrast in fiscal policies between the two countries. It is probably true that in these countries I picked extreme representatives of the two different schools of thought. In Britain the necessaries of life are not only undertaxed, they are strongly subsidized with subsequent need for additional taxation elsewhere.

But on everything else, both direct and indirect taxation fall with extraordinary severity. Most wage earners pay substantial income tax and in addition immense taxation is imposed upon the modest amenities of the English workingman's life, beer and tobacco. Prohibitive purchase tax falls on many classes of household goods which would be regarded as necessaries in any country, and therefore, as a consequence of all this, production is sluggish and there are constant demands for higher money wages. A high official of the British Treasury agreed with me that the only way to reverse the process was to make the necessaries of life much dearer and the amenities much cheaper. This is what Italy has done and her production is increasing with extraordinary rapidity, while prices are stationary or even falling. The Italian has to work hard to buy the necessaries of life, but a slight further effort will bring him some of the amenities which are almost unobtainable in Britain. Italy has virtually no income tax and relies upon a system of indirect taxation, which falls, quite shamelessly, upon the necessaries of life.

If therefore, you think that you can advocate such a policy for the United States, you may be able to go a few points beyond the 25-percent limit without causing prices and incomes to rise.

. . . .

Yours truly,
Colin Clark

NEW SOURCES OF LIGHT ON INTERGOVERNMENTAL FISCAL RELATIONS

HAROLD M. GROVES *

INTERGOVERNMENTAL fiscal relations, as a problem of public finance, have attracted much attention in recent years. One part of the problem has its root in the differential centralization of revenues and expenditures. Involved here is the critical evaluation of the devices used to fill this gap, especially aids and shared taxes. Another part of the problem is overlapping taxes with their waste of administrative resources and their unplanned accumulation of burden. A further concern is for the adequacy of sources of revenue that lie within the discretion of municipalities. Overlying all of these aspects is the question of degree of centralization in government that should be sanctioned in view of all the prospective consequences.

Perhaps some light on this area can be had from international comparisons, especially including countries outside the Anglo-Saxon circle. This, at any rate, is the assumption on which this article is written. It lays no claim to completeness as to coverage either among countries or specific details, but does, I hope, provide an adequate basis for significant generalization.

* The author is professor of economics at the University of Wisconsin.

It is fair to conclude from the literature on intergovernmental fiscal relations in the United States and the British Commonwealth that the following propositions enjoy support ranking them close to dogmas: (1) That the general property tax or some modification of it is a uniquely suitable source of local tax revenues;[1] (2) That overlapping taxation (particularly of income) is an unmitigated evil attributable to ineptness in planning the tax system; and (3) That the institution of aids (from central governments) is the sovereign remedy to bridge the gap resulting from the alleged fact that the administration of taxes should be centralized much more than responsibility for expenditures.

The author is and has been skeptical of all these " dogmas " and he finds fortification for his doubts in certain foreign experience not widely known or considered in this country, particularly the experience of the Scandinavian countries.

[1] It is true that in recent years many municipalities (including New York City and Philadelphia) have been experimenting with and obtaining substantial revenue from new sources; but the critics have not been happy about these innovations and they are especially skeptical of the aspiration of municipalities for a share in the direct use of personal taxes which it is thought could lead only to confusion worst confounded.

The achievements of the Scandinavian countries in the field of intergovernmental fiscal relations can be described in outline form as follows:

1) The Scandinavian countries maintain a relatively high degree of decentralization in government. Some comparative data on local taxes (expressed as a percentage of total taxes) were presented by a recent bulletin [2] as follows:

Country	Year	Per Cent Local Taxes of Total
Switzerland	1949	51
Norway	1948–49	32
Denmark	1948–49	25
Sweden	1948–49	25
Italy	1948–49	18
Finland	1947	17
Germany	1949–50	14
France	1949	13
Netherlands	1947	10
United Kingdom	1949–50	8
Belgium	1949	6

The comparable figure for the United States in 1949 was about 25 per cent.

These figures speak for themselves though they may be amplified and interpreted with the following observations: Switzerland, the United States, and Germany employ federal systems and these make for decentralization. The Swiss experience is nevertheless remarkable and is attributed in no small degree to the Swiss devotion to the idea of decentralization. It is especially remarkable in so small a country where, other things being equal, the feasibility of centralization should be greatest. The Scandinavian situation prevails in countries that are also small and, in their case, relatively homogeneous in population. Moreover, the propensity for decentralization has survived long periods of social democratic leadership. While it is probably hazardous to generalize on this latter political factor, one may express the opinion that socialists (especially the Marxian variety) are inclined to a materialistic outlook which places great emphasis on a broad diffusion of economic goods without too much regard for associated intangibles.[3]

2) Scandinavian decentralization seems the more remarkable when it is observed that it is fortified with only very minor use of the impersonal general property tax. This tax is confined to real estate and it is much less emphasized than our property tax. In Norway [4] where the real property tax seldom amounts to more than seven mills on capital value, its importance is so small and its prestige so low that there is serious consideration of abandoning it entirely. Americans and Britons may be shocked to learn that local government running to nearly a third of total public outlay could be financed without any general property

[2] Economic Commission for Europe (Research and Planning Division), "Changes in the Structure of Taxation in Europe," *Economic Bulletin for Europe*, Vol. II, No. 3 (Geneva: January, 1951), p. 59.

[3] It would be enlightening, were the data available, to compare local *expenditures* as a ratio to all governmental expenditures. If these data were compared with the tax data presented above, they would yield a measure of the extent of intergovernmental transfer payments. Information for Great Britain indicates that local expenditures financed by local taxes are less than half of total local expenditures.

[4] In this outline the author features the experience of Norway, the Scandinavian country with which he is most familiar. However, the main features of intergovernmental relations and of the tax systems are substantially alike in Norway, Sweden, and Denmark.

tax at all. Those who accept the general property tax as "pretty bad but inevitable" might well take a look at this!

3) The genius of the Scandinavian system is its major use of an institution largely undeveloped in this country, namely, the supplement.[5] National taxes are so selected and devised that local governments can use the same bases (with suitable modifications), and local and national taxes can be administered by a single agency and operation. A supplement, it will be recalled, differs from a shared tax in one important respect; it leaves discretion to local governments to adapt the levy to their own tastes and needs. This is significant for local democracy and economy because it preserves the sense that local citizens are spending their own money as they see fit. Supplements differ from independent overlapping taxes in that the wastes of dual administration and compliance are avoided.

4) The two taxes which constitute the backbone of the Scandinavian revenue systems are the net income tax and the net worth or (personal) capital tax. The capital tax is a conservatively graduated tax on the net assets of individual taxpayers. The two taxes are closely integrated to achieve a result not radically different from that which the British accomplish with a single levy on income by including the imputed annual value of owner-occupied premises in income and by taxing earned and unearned income at different rates. It is worthy of note that under the Scandinavian system the *local* taxpayer who contemplates additional expenditures has mainly progressive-personal levies to consider for their financing.

5) At the national level these taxes are applied with substantial progression (with relatively generous personal exemptions and graduated rates); at the local level they are appropriately less progressive (with more moderate personal exemptions and less, if any, graduation).

Our own situation, in contrast, provides state levies on income that are more progressive (in terms of liability) over an important range of income than the national tax. This makes these levies vulnerable to the ravages of the business cycle and to persistent attack on the score that industry is migrating to avoid the levy. Municipal income taxes, such as we have, go to the other extreme, providing no exemptions and ignoring important elements of personal income. We have no capital tax.

6) Local governments, under the Scandinavian system, are left substantial discretion both as to the pattern of exemption and rates. In Norway, for instance, local governments may choose any one of nine patterns of exemptions, the lowest allowing about one-third of the national scale. Rates are adjusted according to local expenditures but may not exceed a maximum of $17\frac{1}{2}$ per cent in the case of net income. Sufficient equalization aids are provided to insure a minimum level of

[5] No doubt our most general experience with supplements (though not recognized as such) is in the case of state and county additions to the general property tax. The experience has not been a happy one but the reasons (which need not be examined here) are not of such a character that they discredit the supplement generally.

governmental services with taxes held to the statutory limits.[6]

7) Adminstration of these taxes (at least in Norway and Denmark) is primarily a local function though there is substantial state supervision. This dubious feature presents problems, and it is currently being reexamined.

It may be useful to contrast briefly the pattern outlined above with that of Switzerland, Germany, Great Britain, and Canada.

The Swiss tax system has much in common with our own. Their's is a federal system, characterized by much uncoordinated overlapping. Net income taxes in Switzerland not infrequently run three deep in number. Cantonal taxes are not even deductible in arriving at the national tax base.[7] Diverse rules of jurisdiction result in considerable and highly inequitable territorial multiple taxation. The Swiss make use of the capital or net worth tax as well as the impersonal general property tax.

During the Weimar Republic and the Nazi regime the Germans developed a highly elaborate and extensive system of centrally-collected, locally-shared taxes. This tradition in the main has been preserved in the postwar reorganization of government in Western Germany. In postwar Germany, however, centrally imposed taxes are collected by the Länder (states) and are divided according to formula. Thus, the important income tax collection is divided 75 per cent to the Länder and 25 per cent to the national government. There is also extensive separation of sources; the death tax, the beer tax, and the capital tax are assigned to the Länder, and the turnover tax and the tariff to the central government. Unfortunately, these arrangements are nailed down with undue inflexibility in a constitutional document not easily modified. Moreover, the system gives scant leeway for the exercise of discretion at the lower levels of government. Some equalization is contemplated but this function is delegated in the main to the upper house of the German parliament.

The British system makes heavy use of the so-called block grant, though it also employs a specific aid for education. Under the block grant the central government supplies municipalities in which the per capita taxable wealth is below average with the equivalent of a tax base equal to the difference between their existing base and the average. The state then pays on this differential base, along with the local unit on its actual base, such levies as the local government may decide to impose. There is some weighting of population to adjust for differing educational and highway needs. The program is economical in its emphasis upon equalization, and it avoids distortion by aiding local expenditure without (much) regard for functional patterns of outlay.

[6] Typically, the equalization process, too, provides unique features; it consists largely of sharing of local revenues and expenditures directly without benefit of central grants in aid. The funds come from jointly collected municipal income and property taxes prescribed by parliament for the equalization purpose. The Scandinavians attach considerable importance to the fact that equalization measures are handled by bodies created by municipalities in cooperation, and that they are using monies collected at the local level with rather limited central government interference.

[7] No deduction for municipal income taxes is provided in Norway either but the control of the municipal levies by the central government largely eliminates the incoordination problem.

The weakness lies in the pitifully inadequate, sources of independent local revenue. Local units rely on a sort of general property tax—the " rates "—but they constitute a highly restricted tax, confined to real estate and with agricultural property entirely and industrial property three-quarters derated. Direct centralization of expenditure has gained ground rapidly in Britain.

The Canadians have a mixed system based largely on agreements between the provinces and central government. Its main feature consists of central collection of income and death taxes with a return to the provinces of a substantial portion on a per capita basis. This leaves municipalities (and provinces) which may wish to extend the frontiers of government the indelectable diet of property taxes and sales taxes.

Now what of the implications of this experience abroad for our own problem? We have had considerable protest, though usually sporadic, against our overlapping taxes (income, death, motor fuel, liquor, tobacco, and so forth). Federal and state aids have grown steadily and rapidly and with little or no eye to pattern. Municipalities complain bitterly about straight jackets. Recently some have revolted or have received state sanction to broaden their tax systems. But in general the view prevails that the general property tax is and must continue to be the major (and only truly elastic) source of local revenue.

To this critic these trends and attitudes appear to offer scant ground for satisfaction. Overlapping taxes might be acceptable if we were making any substantial progress toward the elimination of administrative duplication. The aid system is admirably adapted to equalize and insure minimum standards; it also has valid uses beyond these objectives, but there is real danger of its being overworked. Municipalities that cry for more financial freedom have a valid case.

The development of state sanction for a broader municipal tax base in New York and Pennsylvania can be persuasively defended, but at best it leaves much to be desired. The New York development allows municipalities no choice but to substitute one regressive type of levy for another. The Pennsylvania experiment permits municipalities to levy only upon what the state might tax but does not. More promising would be the permission to levy upon what the state does tax (supplement) with allowance for a range of choice both as to the base of the levy and its degree.

True, our federal system makes the problem much more complicated than that of some other countries. And our elaborate constitutional restrictions currently preclude the development of a capital tax. But no one will deny that there is plenty of room for progress within these restrictions.

In Britain one finds a commendable aid system but an unconscionable neglect of local tax sustenance. In the Dominions one finds mainly highly mechanistic systems that collect and distribute huge sums by formula. This practice offers little encouragement to those who see a fundamental of democracy at stake in allowing groups and individuals to make their own decisions on matters that concern mainly themselves. In Germany and Switzerland one finds principally our own problems in greater degree. Why not look to the Scandinavian countries for some of the answers?

THE BRITISH REVALUATION OF REAL ESTATE FOR LOCAL TAXATION

C. LOWELL HARRISS *

WHAT is this thing worth? This simple question lies at the heart of a host of problems. Many are solved in the market where opposing interests are reflected, crudely or with great refinement. Some must be settled, however, by more or less one-sided judgment. The results are not always models of well-informed, sophisticated analysis! In fact, in one of the most important of such situations, valuation for purposes of local taxation, the valuations are often execrable. Yet sloppy, biased, unequal, hit-or-miss tax valuations are not unavoidable, and some jurisdictions have pointed the way toward much improvement.

American students of public finance may be interested in the current British program of revaluing real estate for purposes of local finance. I had an opportunity to discuss the program with a few of the responsible British officials last summer and also to examine the procedures of one of the largest local offices. The following notes, drawn from this brief experience, give at least more information than I had found in America; they are by no means a thorough, scholarly analysis.

* The author is associate professor of economics at Columbia University.

Reasons for revaluation. As in this country, British local governments rely to a considerable extent upon taxes on real estate, termed " rates." Moreover, some of the important financial grants from the central government are distributed on the basis of the valuations of property made for local taxation (the rates). The central government thereby has an interest in local valuations, and each local government has an interest in the valuations made by all others. These valuations, made by local men, have been of widely varying quality but with a predominant tendency to underassess more than nominally and very unequally. The grant distribution was obviously distorted. How familiar this all sounds!

Local Government Act, 1948. The last general revaluation was made in 1934 (by local authorities). Though changes in individual cases have been made constantly, the present local tax base and the basis for grants is still essentially that of the 1930's. As a part of its postwar program, the Labor government decided that revaluation should be done by a staff directed by the central government. Under the Local Government Act, 1948, therefore, Parliament took the job away

from local authorities as of 1950 and directed the Board of Inland Revenue to complete a revaluation of all real estate in England and Wales by 1953 and thereafter every five years. Scotland was not included because it has used different methods. It is now clear that the job cannot be done well in the time allowed, and it is likely that Parliament will extend the time limit rather than force a substantial sacrifice in quality.

Decentralization. The original plans provided for much decentralization. The London headquarters is literally a planning and directing organization. A total of 270 local offices, reporting to 14 regional offices, are now operating. In many cases the premises are the same as those formerly used by the local authorities.

To prevent this decentralized organization from duplicating the old local system, the central authorities are relying upon supervision, carefully prepared instructions, and the fact that the staffs are now working for, and responsible to, the national government. While it has not yet been possible to test the result of the control system fully, the chief officials seem optimistic. The methods of valuation being used, described below, provide easier control of local staffs than would be possible in the United States.

Staffing. Developing a competent staff has been difficult. Most of the former local staffs were taken over with some reshuffling, resignations, and dismissals. The quality varied widely. In general, the shift brought at least slightly higher salaries, welcome compensation for the unpleasant loss of independence. Some additional appointments have been made. Yet because of widespread opposition to expansion of the civil service and because qualified valuers (appraisers) cannot be hired at the salaries the government will pay, the staff has not been built to the level needed to do the job well and on schedule. Though there are deficiencies at all levels, the most serious shortage seems to be for the positions of top operating responsibility. The private demand for appraisers is large, and the number of experienced ones so small that even if the government offered higher salaries and recruited more vigorously, it probably could not get enough men to accomplish the task it set itself.

The work week is 45½ hours, an increase of more than one-tenth over the prewar schedule. Salaries are hard to compare with those in the American government; they seem to compare favorably, however, and apparently provide a wider range from bottom to top. Though they have increased somewhat, salaries have by no means kept pace with prices. It is probable that the quality of the staff is higher than could be obtained if recruitment had to be done at present salary levels without drawing on the large body of civil servants recruited in the past.

British tax base. The British property tax base, what must be appraised, is not the capital value, as in this country, but the annual income. The tax is expressed in terms of the rental value.[1] Much more commonly than in this country, in fact generally, the tax is paid by the occupant even if he is a

[1] The rates vary from community to community. It is hard to compare the burden which they impose with American property taxes, but they seem to be not greatly different from ours—perhaps a bit higher.

renter. Certain industrial properties are granted large reductions (three-fourths) as the result of a depression policy of encouraging manufacturing and closely related activities. Agricultural land and buildings are wholly relieved from rates.

Utilities, in practice, get special treatment; I gather that treatment is not fully consistent and in fact brings memories of American problems. Railways and electricity boards are not now assessed for local rates. Instead they pay a lump sum based on past valuations, and this lump sum is apportioned among the local authorities in proportion to their ratable value. This arrangement has led to a considerable saving in time and manpower. Other utilities are assessed by reference to profits. After deducting operating expenses, the net profit is reduced by an allowance representing the amount which the rational tenant would require as a return on his capital and his effort. The remainder is taken to be the amount the tenant could afford to pay by way of rent and rates, and the valuation is based on this amount.

The *unit of taxation* is somewhat different from ours, being not what we would term a parcel or a property but a hereditament. The tax base does not include tangible or intangible personal property and in this respect seems very similar to the New York base.[2]

Methods of valuing real estate (other than utilities). The chief method of determining annual value differs in important respects from methods used in the United States. The first step is to get reports from owners and tenants of rental arrangements. The next step is to make flat rate deductions for repairs and maintenance according to schedules enacted by Parliament. In effect, therefore, the problem is to determine the gross rental value; as a rule the rest follows automatically. Refinements to produce equity are sacrificed to administrative convenience. The taxpayer does not have the option, as under the somewhat similar system of arbitrary deductions used in the United States income tax, and the British as well, of deducting the actual expenses if they are higher.[3]

The gross value is not necessarily the actual rent (if any) being paid for a property. It is rather the rental value based on the generality of rents being paid for comparable properties. These rents are reduced to unit factors. The methods seem generally similar to those used in this country (at least by the better administrations) with the important exception that land and improvement values are not explicitly separated. The rental per square foot is computed where the data are available; the results then help indicate the values for other properties, but an element of judgment is necessary.

Sales prices play a less important role than in this country. Yet they provide some check on the rental figures. For some properties the British use what is essentially our "reproduction cost minus depreciation"; I gathered that they often feel about as uncertain of the quality of the results as American assessors but equally unable to find a better method for some properties.

[2] Statutory provision settles most potential problems of deciding what must be included.

[3] In fact it would probably be clumsy to try to allow deduction of actual outlays where the renter is the taxpayer and the owner provides the services.

Bases of assessment. Two distinct bases of assessment are provided by the 1948 act. Properties other than dwelling houses are to be valued at current rental values and dwelling houses at the rental values of 1939. The reason for the difference is that the rents of dwelling houses are largely controlled at or about the 1939 level. There is no free market in houses for renting, and consequently there are no figures of current value available. The rental values of industrial and commercial property have increased substantially since 1939. One result, of course, will be a considerable shift of taxes from homeowners and users of residential property to the business community.

Records available. The central government took over the local government records. In a few cases they were very good, but more generally they left much to be desired, and in some cases they were extremely poor. I was able to examine samples in a district which was said to be one of the best. Compared with New York City, which by American standards has good records, I should say that the land maps were less satisfactory but the other records more complete. Though they were not organized as conveniently, perhaps, as in New York, they contained more detail about how the tax was actually computed, the economic history of the property,[4] and floor plans. In most districts the British face a big task of getting up-to-date information on the physical characteristics of properties. They must also get complete new economic data.

Procedures. To get economic data, the government requires owners and users to supply information on questionnaires. There are twenty-six forms, each for one type of property. A brief review of a dozen or so convinced me that they were skillfully designed to get the kind of information needed for the British type of assessment. They vary greatly. The authorities are supported by legal compulsion on owners and users to comply. The forms are sent by mail, addressed by name if that is known and, if not, by the address.[5] They are being mailed as rapidly as the replies can be processed. The authorities state that willful error in reporting seems rare, but of course there are errors from ignorance or carelessness. More serious is the fact that respondents often cannot supply all the data needed for the valuation, notably, of course, where property is owner occupied. When the forms are returned, the data are examined by a valuer (assessor); he will ordinarily be working with forms for generally similar properties and will soon be able then to fix a value which will stand. In some cases more data will be requested from the owner or user by mail. Moreover, the valuers spend considerable time in the field making intensive studies of particular properties. I gathered that though relatively few properties get thorough field analysis, these absorb much effort and that the staff would like to be able to make detailed investigations in more cases. One feature of these studies which contrasts with typical American procedure is that taxpayers and their representatives commonly participate actively and in fact help in the process.

[4] Though the last general valuation was made in 1934, changes might have been necessary many times later (based on 1934 values) as the property or its use changed. Whenever some or all of a parcel became vacant, tax liability ceased until the space was reoccupied.

[5] The latter would hardly be adequate in the United States where the tax attaches to the property and where the occupant may have no responsibility for the tax.

Review and litigation. When the new values are determined, they will be recorded in books which will be open for public scrutiny for three weeks. Taxpayers may request changes by making " proposals " of what they believe would be correct values. These proposals are considered first by the valuation staff, which in fact has power to make changes. The authorities expect most cases to be settled at this level. When they are not, however, appeal will go to a Local Valuation Court composed ordinarily of three men drawn from a larger panel. This is a lay tribunal which functions without much formality, serves without pay, and is apparently designed to focus informed common sense on the problem.

Cases that are not settled by this review go to the Lands Tribunal. This body is, in essence, a special court established about two years ago to hear disputes on questions involving land. Here again, each dispute or series of disputes is heard by a body, ordinarily of three men, drawn from a panel of six of whom three are lawyers, and the others surveyors and valuers. Selection is made by the Lord Chancellor as the supreme judicial authority. The members are paid fixed salaries which apparently are attractive. Neither party is required to have legal representation. When questions of law are involved, the Board of Inland Revenue are represented, normally by a staff attorney, more rarely by outside counsel.

Two higher levels of review on questions of law are provided, the last being the House of Lords. Shortly after the work was centralized, the authorities found a vast amount of clear or possible conflict among local officials on the interpretation of legal points. Central administration requires uniformity of practice and the authorities have been working toward this end. In scores of cases there is real doubt about which local interpretation is right, and the Inland Revenue have instituted a policy of pressing such cases to at least the lower level of national court to get a national precedent. Out of fairness to taxpayers, the government pays some or all of the legal costs of taxpayers when the litigation is pressed to serve the national convenience! In the higher courts the parties are invariably represented by counsel.

Use of private valuers. For roughly a dozen types of specialized properties —e.g., race tracks, theaters,—the Inland Revenue have retained private valuers. The reason is simple—local staffs could not have men competent to handle well the special problems. The central office could not hope in present conditions to hire valuers with the necessary training; ordinarily there were few qualified men in the country, and they could not be attracted by the salaries and other conditions of government employment; moreover, the need was chiefly temporary. For future revaluations, however, the Inland Revenue hope to train their own staff of specialists. In each case where outside experts were hired, the fees were arranged by negotiation and were fixed below the standard professional rates. It is too early to judge the results fully. The contracts give the government power to prescribe the principles and methods to be used. In one case the

preliminary results showed that the private valuer's methods did not conform with those which the Inland Revenue officials believed most appropriate. Frank discussions with the valuer induced him to revise his methods to suit the officials.

Relations to income tax valuations. In Britain the measure of taxable income includes the estimated annual value of owner-occupied real estate. The Inland Revenue have always been the authority responsible for this work. In the past they generally used the values fixed for local taxing (rating) purposes except in areas where the local assessments were notably low. Now that the valuation of property for local taxation is in Inland Revenue hands it seems likely that the rating values will always be followed for income tax purposes. To date, however, no reassessment of property for income tax purposes has been announced.

INTERGOVERNMENTAL TAX COORDINATION: RECORD AND PROSPECT

L. L. ECKER-RACZ *

THE SUBJECT of intergovernmental tax relations has received a great deal of attention over the years. A large share of this attention, however, seems to have been devoted to urging studies of the problem or to recommendations for changing the allocation of tax sources between the federal government and the states. There appears to be no widespread awareness of the extent to which coordination has progressed and what has already been accomplished.

Although not without prior serious study, the subject received its most comprehensive treatment in the report submitted to the Secretary of the Treasury in 1942 by the Special Committee on Intergovernmental Fiscal Relations.[1] This study has provided the basic setting for most recent discussions of the problem in the United States. It not only explored most of the issues in their varied aspects but also advanced an action program.

The essential contribution of this study was the recognition that the problem must be approached with the

* The author is an economist with the U. S. Treasury Department, but the views here expressed do not necessarily reflect the views of that agency. This article is an expansion of a paper read to the 1952 Conference of the National Association of State Budget Officers at Louisville, Kentucky, and was prepared with the assistance of the author's associates, particularly F. Newell Campbell and Anita Wells.

1 "Federal, State, and Local Government Fiscal Relations" (S. Doc. No. 69, 78th Cong., 1st sess.), 1943. The committee consisted of Harold M. Groves, Luther Gulick, and Mabel Newcomer. The most comprehensive earlier treatment of the subject is "Conflicting Taxation," the 1935 Progress Report of the Interstate Commission on Conflicting Taxation, published jointly by the American Legislators' Association and the Council of State Governments. The subject was resurveyed in the report of the Joint Committee of the American Bar Association, the National Tax Association, and the National Association of Tax Administrators on "The Coordination of Federal, State, and Local Taxation" in 1947. More recently, the Hoover Commission (The Commission on Organization of the Executive Branch of the Government) published a report on "Federal-State Relations" prepared for it by the Council of State Governments (S. Doc. No. 81, 81st Cong., 1st sess.), March, 1949.

view of developing a solution within the framework of the existing division of powers between the federal and state governments. Although the resulting tax overlapping creates problems, this coordinate governmental existence has been a basic factor in the strength of our political system. Accordingly, the study reached the conclusion that theoretically desirable allocations of tax sources must give way to more pragmatic adjustments which preserve and strengthen independent taxing powers.

While the report proposed formal governmental machinery for handling these questions, it placed its faith primarily in a piecemeal attack on problems as they developed. It observed that hopes for a comprehensive readjustment of intergovernmental fiscal relations were doomed to disappointment.

Experience has confirmed the conviction that coordination efforts would indeed have been barren if it had been necessary to await the time when all concerned could agree upon some comprehensive reform program. In the meantime, there has evolved a considerable record of accomplishment through a gradual process of adjustment. This has largely escaped public attention; much of it has been effected without legislative action and through informal conferences and agreements between federal, state, and local officials. An analysis of the record suggests that problems which en bloc look formidable and require "more study before action can be taken," can actually be resolved if tackled one by one as they develop.

An example of encouraging progress is afforded by the conference of federal officials and representatives of state and local governments held at the invitation of the Secretary of the Treasury in April, 1949. This conference provided an opportunity for discussing a number of problems of mutual interest in the field of intergovernmental fiscal relations and resulted in an undertaking to resolve specific problems and to provide facilities for considering other questions.[2] The intergovernmental cooperation in implementing the conference agreements has provided concrete results which will be discussed in some detail below.

Proposals for further study continue to emanate from numerous sources. There has been notably little change in these proposals as they have been advanced for 30 years or more. Less than a year ago the House of Representatives instructed the Committee on Ways and Means to study "means of eliminating competition, overlapping, and duplication of sources of Federal, State and local taxes."[3] In considering the Hoover Commission's reorganization proposals, congressional committees have been studying bills proposing the establishment of a commission to study and

[2] For a state tax administrator's report of this conference, see a paper given by Emory C. Glander (then Tax Commissioner of Ohio and President of the National Association of Tax Administrators) before the Seventeenth Annual Conference of NATA, 1949. With respect to the desirability of approaching the problem of tax coordination on a problem-by-problem basis rather than attempting to revolutionize intergovernmental tax relations, Mr. Glander observed: "I have often felt . . . that what we have been trying to do in many respects has been, by some magic wave of the wand, to invoke a tax millennium. . . . It is always well to philosophize about what ought to be done, but sooner or later you come to stark realities and you realize that you have to begin whittling away at one small problem at a time, and that in those whittling-away processes ultimately you approach some worthwhile results."

[3] H. Res. 414, agreed to on September 27, 1951.

report on action that should be taken.[4]

The persistence of such proposals poses the question whether prospects for coordination along the informal lines of the past hold adequate promise of meeting the complexity of problems left in the wake of the vastly expanded revenue requirements of the war and defense efforts. The roots of the reluctance to take more definitive action may stem from the belief that a formal realignment of taxing powers would open up issues impinging upon the very foundations of our governmental structure. Considering the vital effect a realignment in taxing powers can have on the relative strength of national and local governments, the burden of proof must rest with those proposing a fundamental change.

The need for revenue has increased at all levels of government as the public's demand for more and better services has continued to increase. The search for additional revenues to cover these larger requirements has resulted in the simultaneous use of the same sources of revenue at two and, in some cases, at three governmental levels. This trend increasingly has put to the test the capacity of familiar coordination devices to meet problems of overlapping taxation. A brief review of the fiscal outlook at the three governmental levels can provide some needed realism to a consideration of these matters.

[4] Hearings before the House Committee on Expenditures in the Executive Departments on bills relating to Commission on Organization Recommendations, 82d Cong., 2d sess; and Joint Hearings before the Subcommittees on Intergovernmental Relations of the Senate and House Committees on Expenditures in the Executive Departments on bills proposing a National Commission on Intergovernmental Relations, 81st Cong., 1st sess.

FISCAL OUTLOOK

The salient facts about federal finances need but passing notice here. To the casual observer, exposed to public discussions of federal deficits for years on end, it may come as a surprise that for the postwar period as a whole revenues have sufficed thus far to cover expenditures. For the six-year period, July 1, 1946-June 30, 1952, budget receipts exceeded expenditures by almost \$4 billion. On a cash basis a surplus was recorded in all but one of the six fiscal years, and the aggregate net cash surplus amounted to \$22 billion. The three large tax bills enacted since Korea increased the revenue-producing strength of the federal tax system by about one-third, or more than \$15 billion a year. As a result, budget expenditures during the past two fiscal years have fallen short of receipts by only about ½ of 1 per cent, and the cash budget has been in balance in both years.

In the near future, however, substantial deficits seem inevitable. In the current year budget expenditures are not likely to fall substantially below \$80 billion. If the defense program unfolds as now projected, fiscal year 1954 expenditures will be still higher. On the revenue side, the \$71 billion estimate for the current fiscal year holds promise of proving to be optimistic since corporate profits are now running at a lower rate than expected at the beginning of the year. On balance, therefore, something of the general magnitude of a \$10 billion conventional budget deficit and a \$5 billion cash deficit is in sight for each fiscal year, 1953 and 1954.

The longer-run budgetary outlook

hinges largely on international developments, and there is little real evidence that the international armament race will soon subside. In the happy event that the world situation permits the defense program to be tapered off, a large backlog of civilian requirements will clamor for congressional approval. Moreover, federal revenues can be maintained at their present levels only by affirmative action on the part of Congress to extend both the excess-profits tax and the increased rates enacted under the Revenue Act of 1951. These are scheduled to expire before the end of the next fiscal year. A contributing factor to the long-run outlook is that the next Congress will find it difficult to increase revenues or to replace expiring taxes. Tax rates have been pushed far in most areas excepting those enjoying preferential treatment. The only readily available new revenue source of substantial magnitude is some form of a general consumption tax. The fact that vocal support for this tax has subsided may reflect increasing recognition that it would be prudent to reserve this revenue source for a more critical occasion.

At the state government level the fiscal situation today is relatively good, although those responsible for fiscal management must be continually alert to keep revenues abreast of expenditures. In the two most recent fiscal years state general revenue increased at a faster rate than state expenditures for the first time since 1947, but state indebtedness continued to increase.

The present relatively satisfactory situation is partially a by-product of the high level of national economic activity. This has increased the proceeds of income and sales taxes beyond the most optimistic expectations. General sales taxes, for example, which reached the billion dollar level for the first time in 1947 had almost doubled by 1951. At the same time general prosperity has retarded the rising trend in welfare expenditures.

Although some states are enjoying surpluses, many are having to scurry to balance their budgets. During 1951 more than half of the 46 states which met in legislative session found it necessary to increase the rates of at least one major tax. Three states adopted general sales taxes for the first time and two increased old sales tax rates. Cigarette taxes were levied for the first time in two states,[5] and there were several examples of increases in income taxes, more examples of increases in liquor taxes, and even more in gasoline taxes.

The Federation of Tax Administrators' analysis of eleven budgets presented to state legislatures in 1952 indicates that although revenues are expected to continue increasing, expenditures are expected to increase even faster, so that state treasury balances will diminish.[6] Although surpluses were accumulated in a number of states during the fiscal year 1951, only two governors proposed tax reductions. The governors of some of the larger states which had substantial surpluses in 1951 opposed tax reduction proposals based on these surpluses and stressed the uncertain revenue outlook and growing state needs. In other states the projected surpluses were too small to per-

[5] Oregon's new cigarette tax, however, will not go into effect until approved by popular referendum in November, 1952.

[6] Rothenberg, Leon (Member of Staff, Federation of Tax Administrators), "State Budgets—1952," *State Government*, May, 1952.

mit consideration of tax reduction. In still others, balanced budgets could be reported only on the assumption that temporary rate increases enacted in 1950 or 1951 would be extended.

At the local level the fiscal horizon is even less bright. Communities in most parts of the country are striving to find ways and means of providing improved services demanded on an increasing scale by a citizenry which desires to match its improved personal standard of living with improvements in governmental services. Everywhere people are demanding better school buildings and better instructional facilities, more parks and playgrounds, improved roads, and more adequate relief and welfare standards.

Deferment of construction programs during the war, a high birth rate, and shifts in population, incident to both the defense program and industrial prosperity, have aggravated the situation in particular areas. The problems are especially difficult in those communities which, for one reason or another, are not sharing in the national prosperity.

To meet increasing requirements, local governments continue to depend largely on the property tax. For the country as a whole, real estate still accounts for almost 90 cents of every dollar of local tax revenue. While the large volume of postwar construction and rising real estate values have increased the base of this tax, other developments have contributed to its reduction. The current trend toward decentralization of population and shopping centers and other businesses creates fiscal difficulties for the cities. The population movement from cities to suburban areas, together with the changing character of city populations (to persons with relatively less tax-paying capacity and greater potential need for welfare services), tend to retard growth of the property tax base at the same time that per capita governmental costs are rising. The provision of public services in the fringe areas is also creating problems. Taxpayers within city limits resist high county tax rates to provide an urban standard of services to those living in the unincorporated areas on the city's fringes, not subject to city taxes. This situation has prompted cities to try extending their tax jurisdiction by annexation and to devise revenue sources which will extract some tax contribution from those who work within but reside outside the city limits.

The quest for nonproperty tax revenues is continuing in many communities. The success of such efforts depends on the disposition of state legislatures. Some legislatures have delegated new taxing powers to their subdivisions. This trend is already being reflected in local experimentation with income, sales, admissions, and a variety of selective excise taxes.

On the whole, however, the cities, towns, and counties continue to be tied to the property tax, although some of the larger cities are notable exceptions. Philadelphia, for example, is reported to have derived almost 40 per cent of the city's total tax revenue from its income tax in 1950, and other Pennsylvania cities and some Ohio cities derived even larger proportions of their revenue from this source. In 1950 general sales taxes provided almost 30 per cent of total tax revenue in New Orleans, 25 per cent in New York City, 18 per cent in Denver,

and 16 per cent in Los Angeles.

In a very important sense the problem at the local level is one of state-local relations. Clearly, the public's demand for more and costlier local services can be satisfied in only one of three ways, each of which requires state action. The states can delegate to the localities authority to levy new taxes; they can take over some of the local functions; or they can transfer funds to their localities.

Each of these devices is currently in use. Important developments are recorded in state-local transfers. Localities are looking with increasing frequency to the states for new funds. In the fiscal year 1951, for example, state aid to local governments amounted to almost $5 billion ($4.7) compared with $1.8 billion in 1942. State aid in 1951 included $2.3 billion for education, $1 billion for public welfare, almost $700 million for highways, and almost $125 million for health and hospitals. These transfers to local governments in 1951 represented approximately 35 per cent of total state revenue (including federal grants but excluding insurance trust revenue).[7]

While two variables in the fiscal outlook—international developments and the general condition of the economy—are both susceptible to sudden change, the outlook is for a tight fiscal situation at all governmental levels. Requirements will tend to outpace available revenues. This condition will be aggravated by the growing tax consciousness of the public and the understandable disposition of elected representatives to heed the voters' desire for both more services and less taxes. These fiscal pressures should contribute to the willingness of the governments at all levels to give active support to tax coordination.

APPROACHES TO COORDINATION

Coordination devices fundamentally move in the direction of either (a) separation of tax sources, or (b) the removal of obstacles to duplicate or joint use of the same sources.

Recommendations for separation of sources range all the way from extreme measures which would avoid all overlapping to more modest suggestions for the assignment of some particular tax to jurisdictions peculiarly qualified to use it. However, there is no general agreement as to the specific taxes which should be reassigned and where they should be assigned. The prescriptions are well nigh as numerous as the groups which have examined the subject.[8] Although there have been instances where states have vacated limited areas for the benefit of localities, there has been no general disposition to take similar action at the federal level.

The appeal of the separation of source

[7] Federal grants-in-aid for the fiscal year 1952 are estimated at $2.7 billion or about 12 per cent of total state and local revenues (Budget of the United States for the fiscal year ending June 30, 1953, Special Analysis G, Federal Aid to State and Local Governments, p. 1196).

[8] One group, for example, recommended that the federal government give up death and gift taxes, gasoline, amusement, and liquor license taxes, while the states should give up tobacco taxes. (The Joint Committee of the American Bar Association, the National Tax Association, and the National Association of Tax Administrators, Report, *op. cit.*, pp. 100-102.) Another recommended that the federal government relinquish to the states gasoline, admissions, and amusement taxes, materially reduce the rates on liquor and tobacco, and make some reduction in other excises, while the states should relinquish death taxes. (Council of State Governments' Report prepared for the Hoover Commission, *op. cit.*, pp. 107-108.)

approach lies in the belief that it would strengthen the position of those units of government which would find relief from immediate pressure in the exclusive right to a particular field of taxation. It disregards the countervailing consideration that as one unit gives up a certain source of revenue, it tends to press for the exclusive use of some other source, thus in turn restricting the governmental unit which appeared to gain an initial advantage. If carried far, some units would end up at a considerable disadvantage. Changes in economic conditions and geographical shifts in employment and income could greatly alter the adequacy of a once-favorable tax source. Uneven geographical distribution of tax bases presents a continuing obstacle to efficient separation of sources. Moreover, if sources were assigned according to the criteria of capacity for most efficient operation, some levels of government would be accorded a plethora of revenue potential while others would be left wanting.[9]

Extensive development of separation of revenue sources would inevitably bring in its train new viewpoints on the separation of functions. In this respect, rigid separation of revenue sources would have been more suitable during earlier periods of the country's history when governmental functions followed simpler patterns. Activities such as highway development, education, and welfare services have come to require joint policy making, financing, and administration. The grant-in-aid device has evolved as a compromise method for dealing with this problem, short of extreme allocation of both operation and financing to any single governmental level.

Today a variety of coordination methods are in use which enable two or more levels of government to employ the same revenue source without jeopardy to one another. This development is characteristic of the American democratic process. There is as yet no clear evidence that one method is superior to the others in all cases and should be exclusively adopted. Together they provide a kit of highly flexible coordination tools which can be used to fit varying circumstances and objectives.

A commonly proposed method of federal-state tax coordination is that of tax sharing. This method has not been developed at the federal level. It has been widely used by the states which can take over for their own exclusive use certain tax fields without the con-

[9] It should be made clear that separation of revenue sources does not enjoy universal support. One recent study, for example, found that "This method of tax coordination could well be extended somewhat, but it will provide no panacea because it is not feasible to unscramble all of the overlapping taxation and to set aside independent revenues not utilized by other governments that would be completely sufficient for each layer of government." (Report of the Joint Committee of the American Bar Association, the National Tax Association, and the National Association of Tax Administrators, *op. cit.*, p. 25.) Another report points out that many of the consequences associated with overlapping taxes are related more directly to the volume of taxes than to the fact that there is overlapping and observes "Even if there were complete separation of sources between State and National Governments, neither level would be perfectly free to fix its tax rates, exemptions, and other basic provisions with complete disregard of burdens imposed upon taxpayers by the other level of government." (Report prepared by the Council of State Governments for the Hoover Commission, *op. cit.*, p. 94.) This report also points out that "some forms of tax may be comparatively unsatisfactory for State use unless backed up by an actual or contingent national tax that eliminates the possibility that some States will become tax havens. The present unemployment compensation tax is a case in point."

sent of the localities. It seems less practicable for use by the federal government since arrangements would have to be extremely liberal to induce the states to surrender important taxing powers. Moreover, the device is not without a basic threat to fiscal independence. While it generally assumes sharing on the basis of revenue contributed, experience has shown that it is susceptible of conversion to sharing on the basis of need. It involves, perhaps, more tendency toward centralization than any other coordination device.

Deductibility and tax credits have the common feature of alleviating overlapping taxes while retaining separate powers of tax imposition and administration. Mutual deductibility means that each government's yield is affected by the tax rate of the other. The tax credit, on the other hand, is fixed by the unit of government allowing the credit and may vary all the way from the total amount of tax imposed by such unit to a small fraction of it.

Tax supplements permit the states to use the national tax base or the localities to use the state tax base while retaining independent administration. One of the most serious disadvantages of the tax supplement is the likelihood that the supplemental revenues will fluctuate widely with changes in the taxation policies of the jurisdiction imposing the basic tax.

Uniformity of tax bases and methods of tax computation minimize conflicts by simplifying the taxpayer's work in preparing returns and making possible intergovernmental interchange of tax information, resulting in more efficient and less expensive administration at all levels.

Administrative cooperation is a type of coordination well adapted to the American system of sharing responsibilities by different levels of government. A highly developed form of federal-state administrative cooperation would be either delegated or joint administration. The former involves contractual arrangements under which duplicate administration is eliminated and one level of government collects taxes for the other. Both Canada and Australia experimented with delegated administration of the income tax, but the experiment was suspended during World War II when both national governments took over the exclusive use of the income tax. Under joint administration both levels of government continue to administer their own taxes but in a combined operation through exchange of personnel and other facilities.

Although neither delegated nor joint administration has been worked out in this country, considerable progress has been made in administrative cooperation with benefits of economy in enforcement and compliance. Progress has been most notable in the income tax field, where it has been facilitated by standardization of tax bases and methods of tax computation. Such developments as exchange of information and exchange of audits hold promise of further progress.

The theoretical weakness of the separation of revenue source approach to tax coordination, coupled with the practical implications of the fiscal outlook, suggest that the solution must be sought in other directions. Separation presupposes a larger measure of revenue flexibility than can be anticipated in the near future. Measured consideration

suggests that we must, instead, seek the solution to tax coordination mainly within the framework of overlapping taxes. This point merits emphasis because so much of the discussion of tax coordination, particularly by spokesmen for state and local governments, looks for a solution in the redistribution of tax sources between governments.

The prospect of continuing overlapping taxes, however, is not necessarily a cause for concern. A review of the steps taken within the space of less than two decades covering the widely varied conditions of severe depression and all-out war and postwar prosperity brings to light a great measure of initiative and resourcefulness on the part of those engaged in the improvement and administration of tax laws at all levels of government. This record is presented in some detail in a report submitted recently to the Committee on Ways and Means by the Treasury Department.[10] The high lights of this record are summarized in the section which follows.

COORDINATION IN PROGRESS

a) *Income Taxes*

Federal taxes on incomes and profits today account collectively for over $50 billion and represent over 80 per cent of federal tax receipts. There are also 30-odd state income taxes. While some of the most populous states do not impose income taxes, two-thirds of the states do. In addition, in three states (Kentucky, Ohio, and Pennsylvania) there are local income taxes. This number will be increased by the re-enactment of St. Louis's income tax under a recently renewed authorization. These local income taxes generally are found in states which do not themselves tax individual incomes. In only one state (Kentucky) do income recipients pay three—federal, state, and city—income taxes. The same situation will prevail in St. Louis when its income tax is reinstated. The consequences of these overlapping income taxes are moderated by a variety of coordination devices.

One of the important developments is the tendency of the states to pattern their income taxes on the federal law. This makes for uniformity of tax concepts and facilitates both taxpayer compliance and tax administration. Such devices as the per capita exemption, the standard deduction, and the simplified tax table are gaining increasing use in the states. More than two-thirds of the income tax states allow either a standard deduction or the use of a tax table. The Vermont income tax goes so far as to accept the federal definition of net income for state tax purposes (with certain necessary adjustments). Utah made a move toward simplification in 1951 by granting its taxpayers the right to pay 10 per cent of the federal tax liability on the simplified tax table in lieu of computing the tax under state law provisions.[11] In Alaska the territorial tax is specified as 10 per cent of the federal tax. Much federal-state variation remains, however, and more progress will be required before both taxes can be collected by the same authority, as was done in Australia and Canada before the war.

[10] U. S. Treasury Department, "Federal-State-Local Tax Coordination," Committee Print, 82d Cong., 2d sess. (March 7, 1952).

[11] It appears, however, that 10 per cent of the federal tax is in all cases greater than the tax computed under Utah rates and exemptions so that the device will need modification to become useful.

Another important coordination aid is deductibility. The taxpayer's right to deduct state income taxes for federal tax purposes, and in two-thirds of the income tax states to deduct federal taxes for state purposes, reduces the burden imposed on a taxpayer when a state income tax is added to the federal tax. The effect of the deductibility feature on the combined federal-state tax burden in illustrative cases is shown in Table 1:

where the federal tax is allowed as a deduction for state purposes, the addition of a 10.1 per cent state rate to the 69.2 federal rate raises the combined rate by only 3/10 of 1 per cent, to 69.5 per cent. This means, in effect, that the existence of the federal income tax is little bar to state use of the income tax. On the contrary, it safeguards a state from the fear that its income taxes might drive residents to states without income taxes.[12]

TABLE 1

Effect of Deductibility * on Combined Federal and State Individual Income Tax † for a Married Man with Two Dependents, at Selected Net Income Levels

(Per cent)

Net income before personal exemption ‡	Effective rate of tax				
	Federal (assuming no state tax)	State		Combined federal and state	
		New York	Minnesota (assuming no federal tax)	New York	Minnesota §
$ 20,000	25.0	4.1	6.9	27.6	27.9
50,000	42.2	5.4	9.1	44.0	43.9
100,000	56.0	5.9	9.8	57.5	57.1
200,000	69.2	6.1	10.1	69.9	69.5
1,500,000	88.0 ‖	6.3	10.5	89.3	88.9

* The federal government allows taxpayers to deduct state income taxes in computing net taxable income for federal purposes and, similarly, Minnesota allows deduction of federal tax in computing the state tax. New York does not allow deduction of the federal income tax in computing the state tax.

† Federal rates under Revenue Act of 1951, applicable to taxable year 1952; New York and Minnesota rates under income tax laws applicable to taxes paid in 1952.

‡ Prior to allowable deductions for income taxes.

§ Taking into account reciprocal deductibility under federal and Minnesota taxes.

‖ Taking into account federal maximum effective rate limitation of 88 per cent.

Note.—The effect of deductibility is illustrated only for net income beginning at $20,000, since most low income taxpayers do not itemize deductions but use the standard deduction for both federal and state income tax purposes.

At the $200,000 income level, for example, the federal tax is 69.2 per cent. The addition of New York's 6.1 per cent tax raises the combined federal-state burden only 7/10 of 1 per cent, to 69.9 per cent. In Minnesota,

As a result of the deductibility feature, the addition of the state tax on

[12] It should be noted that the equity of income taxation is not improved by the addition of state deductibility of federal taxes to federal deductibility of states taxes which incidentally reduces appreciably the yield of state income taxes by diminishing the tax base.

top of the federal levy has a relatively minor effect on the marginal tax rate, particularly at the upper income levels. This is illustrated in Table 2.

A conspicuous example of tax coordination is administrative cooperation. Federal income tax returns are open for state inspection, and changes made by federal audit are available to state tax administrators. The states, in addition, are afforded facilities for obtaining copies of federal tax returns, either by providing personnel to copy them or by paying a nominal fee for copies made by the Bureau of Internal Revenue.

One of the most interesting recent developments is the exchange of audit information between federal authorities and a number of the states. Test projects were set up in two states (North Carolina and Wisconsin) in 1950 and proved so successful that three more states (Colorado, Kentucky, and Montana) have been included in the program. Other states have expressed a desire to participate, and further expansion of the program is anticipated in the near future. Participating states receive abstracts of audit information for each changed return showing a deficiency in tax.

TABLE 2

EFFECT OF DEDUCTIBILITY * ON COMBINED FEDERAL AND STATE INDIVIDUAL INCOME TAX MARGINAL RATES, † AT SELECTED SURTAX NET INCOME LEVELS

Surtax net income	Federal marginal rate	State marginal rate ‡	State does not allow deduction for federal tax		State allows deduction for federal tax	
			Combined federal and state marginal rate	Percentage points added by state tax	Combined federal and state marginal rate	Percentage points added by state tax
	Per cent	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*
$ 20,000	62	10	65.80	3.80	63.54	1.54
30,000	67	10	70.30	3.30	68.17	1.17
50,000	77	10	79.30	2.30	77.57	.57
100,000	90	10	91.00	1.00	90.11	.11
200,000	92	10	92.80	.80	92.07	.07

* The federal government allows taxpayers to deduct state income taxes in computing net taxable income for federal purposes. Approximately two-thirds of the income tax states allow deduction of federal tax in computing the state tax.

† The marginal rate is the rate applicable to an additional dollar of income. Federal rates under the Revenue Act of 1951, applicable to taxable year 1952.

‡ The top rate is as high as 10 per cent in only three states (in one of these it is 15 per cent); in two states the top rate is 8 per cent; in 24 states it is no higher than 7 per cent.

NOTE.—The effect of deductibility is illustrated only for net incomes beginning at $20,000, since most low income taxpayers do not itemize deductions but use the standard deduction for both federal and state income tax purposes.

An important feature of the audit exchange program is that states are able to assess deficiencies on the basis of this federal audit information without further field audits. The exchange of audit information means not only economy in tax administration, but it also spares the taxpayer separate visits by

tax administrators. The reduction of duplicating costs of collecting taxes and of irritation and annoyance to taxpayers through such cooperative methods removes some of the most serious objections to overlapping taxes.

The states are providing direct enforcement help to the federal government by withholding federal income taxes from their employees. Legislation passed earlier this year will enable the federal government to reciprocate. It authorizes federal agencies to withhold state income taxes from their employees where states make general use of withholding in income tax administration. Federal agencies already supply the states and local governments with copies of Forms W-2 on federal employees.

Much of what has been said about the individual income tax also applies to the tax on corporation profits.

b) *Inheritance, Estate and Gift Taxes*

Estate and gift taxes contributed less than $800 million, or less than 1.5 per cent of total federal tax revenues, in the fiscal year 1952. The states collected from death and gift taxes in fiscal year 1951 about $200 million, or a little more than 2 per cent of their total tax revenues.

Periodically the proposal is made that the federal government surrender the death tax to the states. From the viewpoint of the states, the compelling argument against reserving the tax for their use is the loss of state revenue that probably would result from a return to the competitive situation that existed prior to adoption of the federal tax credit for state death taxes.

Under the tax credit arrangement taxpayers are allowed to claim taxes paid to states as a partial credit against federal tax liability. The net effect of this device at present is to permit the states to receive 80 per cent of the federal tax under the 1926 law. Within this limit state taxes have the effect of preempting for the states revenue which otherwise would be payable to the federal government. Prior to the adoption of the credit, states were competing with each other for wealthy residents by offering low death taxes or no death tax at all. Every state, except one, now has some form of death tax and most take full advantage of the federal credit. Several state death tax laws as well as many supplementary tax provisions are made contingent upon the continuation of the federal credit. There is every indication that state revenues from this source can best be protected by continuation of the federal tax credit.

Because of the limitation of the credit to 80 per cent of the 1926 federal estate tax liability, however, the credit has only partially succeeded in securing the desired uniformity in the level of state death taxes and has not enabled the states to maximize their revenue from this source. More successful federal-state coordination could be obtained by strengthening and modernizing the crediting device. Such coordination has been impeded by the fact that the overall strength of the federal tax has declined rather than improved. Federal estate and gift tax revenues have failed to keep pace with total federal revenue.

The states have a real stake in supporting an increase in the federal revenue yield from these taxes. If the estate and gift taxes were strengthened at the federal level, not only would the equity of the tax structure be improved, but also a margin of revenue for revis-

ing the credit to the benefit of the states would be provided. The present inadequate federal tax base and serious loopholes prevent the states from expanding their taxes in this field.

c) *Excises*

The federal government derives less than 20 per cent of its tax revenues from excise taxes. The present federal excise structure consists of more than 50 excises, but the bulk of the revenue comes from a relatively small number of taxes. Distilled spirits, beer, cigarettes, and gasoline produced about one-half of the nearly $9 billion derived from excises in the fiscal year 1952.

Selective excises and general sales taxes now yield the states over $5 billion, or almost 60 per cent of their total tax revenues.

Some of the newly adopted local excises overlap both federal and state excises, resulting in three-level and in some cases four-level imposition of particular taxes. General sales taxes are also coming into increasing use by cities and counties. Local sales and excise taxes now produce in the aggregate about half a billion dollars a year.

Tobacco. The federal 8-cent tax per package on cigarettes exists side-by-side with state taxes in 41 states and local taxes in eight states. State taxes range from 2 to 8 cents with 3 cents the most common rate (in 17 states) and produce almost $0.5 billion a year.

There have been some striking developments in the coordination of state and local taxes in this area. In Florida, for example, municipalities may levy a 5-cent tax on a package of cigarettes which can be credited against the state 5-cent rate. Thus, Florida municipalities can put a 5-cent tax on cigarettes without burdening their inhabitants; the burden falls on the State Treasury. In Wyoming the state supplanted the 2-cent local cigarette taxes by a state-collected, locally shared tax of the same rate. New York State recently authorized New York City to impose a 1-cent per package cigarette tax which will be administered jointly by the city and state through the use of a single 4-cent tax stamp.

The states have a special problem of enforcement in the tobacco field because interstate parcel post shipments provide a means of tax evasion. The Jenkins Act passed in 1949 relieves this situation by requiring monthly reports to state administrators by persons who sell cigarettes in interstate commerce and ship them to other than licensed distributors in a state which taxes cigarettes.

The problem of federal-state administrative cooperation is difficult primarily because the federal tax is collected at the manufacturing level from about 50 factories while state taxes are collected from distributors and, in some cases, directly from users. Collection of state taxes at the manufacturing level is now being explored.

One method of coordination frequently proposed is federal and state sharing of revenues. It would be difficult, however, to work out a satisfactory plan of sharing because of the wide variation in existing state tax rates and the difficulty of agreeing on a scale of sharing which will not overcompensate some states at the same time that it undercompensates others.

Liquor. Alcoholic beverages, which constitute the largest single source of

federal excise revenue, produced about $2.5 billion in the fiscal year 1952. The states obtained $0.5 billion from this source in fiscal year 1951. In the 16 monopoly states, which depend largely on profits from liquor sales rather than on taxes, net contributions from their monopoly systems to general funds amounted to more than $150 million.

The opportunity to work out a well-coordinated system of federal-state taxes on alcoholic beverages presented itself at the time of repeal of the 18th Amendment; but, in deference to state freedom in regulating liquor traffic, federal and state governments developed their alcohol tax and control systems independently. Taxation of liquor is tied closely to regulation of liquor consumption which under the 21st Amendment and federal legislation has been left entirely to state determination.

There is wide diversity in state and local tax rates, types of outlets permitted, and types of alcoholic beverages permitted to be sold. Because of this wide variation, the extent of federal-state coordination is limited largely to administrative cooperation. Federal, state, and local enforcement officers cooperate closely in the detection of illicit production. Some information available from federal sources is helpful to the states in collecting the tax on interstate shipments. Federal records showing wholesale shipments of distilled spirits are made available to the states on request. In addition, states are furnished copies of information submitted in connection with federal occupational taxes on wholesale and retail dealers in alcoholic beverages.

Motor fuel. The federal 2-cent tax on gasoline (and diesel fuel) is now producing about $750 million a year. State gasoline tax rates range from 3 cents to 9 cents and produced $1.7 billion in fiscal year 1951, or about 20 per cent of total state tax revenues.

Frequent proposals have been made for the repeal of the federal gasoline tax. It is debatable whether use of this tax by the federal government has been an effective economic barrier to its use by the states. This is suggested by the fact that state gasoline tax rates range from 3 cents per gallon (in Missouri and New Jersey) to 7 cents a gallon in several states and that federal-state-local combined rates reach 12 cents in one state (Mississippi).

Here is a tax which at first glance may appear to be suitable for federal collection and local sharing because of the small number of refineries in the country which makes for efficiency of collection at the federal level. However, variation in requirements among the states, as reflected by existing variation in tax rates, indicates the nature of the problem of working out a basis for sharing.

Admissions tax. Federal admissions taxes now yield about $400 million. Admissions are also taxed in about 26 states, but this tax is not a major revenue item for the states. In recent years it has been proposed with growing frequency that this source be left for local governments. Although admissions taxes are imposed by municipalities in about 15 states, most of the local admissions taxes are concentrated in three states: Ohio, Pennsylvania, and Washington.

The admissions tax has been desig-

nated by representatives of state and local governments as admirably suited for local use. A recent study indicates, however, that in many states municipalities do not have authority to impose such taxes and specific statutory authorization would be required.[13]

In some states local authority to impose such taxes is found in home-rule provisions or charters or is derived from general or specific business licensing powers. The state courts in some cases, however, have interpreted such powers strictly. The Supreme Court of Oregon, for example, recently held invalid a 3 per cent license tax on theatre admissions levied by the city of Eugene on the grounds that it was a sales tax and "did not possess any of the earmarks of a license or occupation tax." The city's charter gave it the right to levy license or occupation taxes but not sales taxes.

Various methods of coordinating federal-state-local admissions taxes have been proposed, including federal rate reduction, federal sharing, and a tax credit.

There is some question as to whether federal rate reduction would remove the obstacles to local utilization of admissions taxes. Further development of admissions taxes by local governments would be delayed by the need for securing enabling legislation in many states. Uneven adoption by various governmental units would leave sharp discriminations between firms operating in the city and in adjoining areas outside the city.

Revenue-sharing might be used as a coordination plan but, regardless of the distribution formula adopted, this method would probably result in lack of correlation between federal distributions and needs and desires for the revenue by states and localities.

The use of the crediting device has been suggested as particularly adaptable to this field of taxation. This approach would effectively remove federal tax rate obstacles to state and local development of the admissions tax to the extent of the credit given. State and local discretion as to using this tax also would be preserved. Local reluctance to adoption arising from fear of competition and other factors would be eliminated. While favoring repeal of the federal admissions tax ultimately, the American Municipal Association has suggested use of the crediting device as an intermediate step.

Local telephone service and electrical energy. Taxes on local telephone service have also been designated by state and local representatives as especially suitable for local use, and repeal or reduction of the federal tax has been proposed. Many localities would require additional authority from their state governments before they could exploit this source of revenue. In only about one-third of the states do cities (and in a few cases counties) have authority to tax telephone companies and sales of telephone service. Where authority exists, the maximum rate which may be imposed is frequently specified. Nevertheless, the tax on local telephone calls is one of the nonproperty sources which can be easily administered at the local level, and increasingly more states are admitting their local subdivisions into this tax field. An important considera-

[13] Federation of Tax Administrators, "Multiple Taxation of Amusements and Selected Utility Services: Federal, State and Local," *Research Report* No. 27 (1950).

tion is the federal government's $300 million revenue stake in this tax.

The federal 3 1/3 per cent tax on sales of electrical energy which was producing $100 million a year was repealed in 1951. This tax was one of the excises cited by state and local representatives as being particularly suitable for local administration. The repeal of the federal tax will provide a practical opportunity for evaluating the effect of federal withdrawal from a particular tax area on the exploitation of this revenue source by states and particularly local governments.

* * * * *

The trend in tax relations between governments in the United States is one of progress reflecting orderly, if at times slow, adjustment to changing conditions within the framework of long-standing institutional arrangements. It is the record of a flexible federal system of government meeting problems as they emerge without indulging in periodic upheavals, even under the strain of sudden and great changes in revenue requirements. The record buttresses the conviction that if the revenue requirements of the federal and state governments preclude their surrendering important tax sources to each other's exclusive use and to their subordinate governments, the continued overlapping of taxes need not necessarily be damaging. With benefit of cooperation between administrators and with proper legislative coordination of the technical provisions of tax laws, overlapping taxes need result in no excessive waste of administrative resources, in no excessive compliance burden on taxpayers, nor in an unplanned pattern of tax-load distribution. However, since state and local governments must of necessity be preoccupied with meeting their revenue needs, it devolves on the federal government, and in the first instance on the Congress, to safeguard the national interest by patterning the federal tax system so that it ameliorates the regressivity or other undesirable features of state and local taxation.

THE TAX SYSTEM OF THE ARGENTINE NATIONAL GOVERNMENT

ERNEST F. PATTERSON *

THE PURPOSE of this article is to describe the tax system of the Argentine National Government and to outline briefly the major stages of its development. Like the United States, Argentina has a federal form of government, but Argentina has always concentrated much greater power in its central government than have we. For this reason a brief preliminary statement indicating the extent of the federal government's jurisdiction may be helpful.

The country, for political purposes, is divided into Provinces, Municipalities, Departamentos (local " county " government units), National Territories, and the Federal Capital District (Buenos Aires). The National Territories are governed by the federal government under the jurisdiction of the Minister of the Interior. The nine Territories comprise between one-third and one-half of the total area of the country and include the rich Territory of La Pampa, which has more land and agricultural wealth than do the Provinces of Salta, Jujuy, Catamarca, La Rioja, and San Luis combined.[1] The city of Buenos Aires, which contains over 20 per cent of the population of the country, is also completely under the authority of the federal government.

General Development

After Argentina declared its independence from Spain in 1810, several years of conflict ensued between the provincial authorities and the central government. Eventually, however, a settlement was reached and formalized in the Constitution of 1860. So far as taxation is concerned, the following principles were codified by this constitution:

1. Customs duties were recognized as the exclusive prerogative of the federal government.

2. Personal, direct taxes—i. e., those taxes which " according to the theory of J. S. Mill, . . . cannot be shifted by the person obliged by law to pay them "—were the exclusive prerogative of the Provinces. Only under extraordinary circumstances and for a limited period of time could they be imposed by the federal government.

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1 Faculdad de Ciencias Económicas (Universidad de Buenos Aires), *Territories Nacionales Chaco, Chubut, La Pampa, Misiones, y Rio Negro* (Buenos Aires: Imprenta de la Universidad, 1942), p. 43.

3. Indirect taxes—mainly excise taxes (impuestos internos)—could be levied by both the Provinces and the National Government.[2]

Following agreement on this division of tax powers, the development of the Argentine tax structure can be divided logically into three periods: the span of years up to 1931; 1931 to 1944; and 1944 to the present.

During the first period, the tax revenues of the National Government were derived mainly from customs duties, as is evident from the data for representative years shown in Table 1. In fact, only once between 1892 and 1931 did customs duties fail to produce more than half the total annual revenue of the federal government. In this same period internal excise taxes comprised the second most important source of revenue; these taxes were often added to provincial levies on the same goods. Thus, "consumption" taxes (customs and excises) consistently produced over 60 per cent of total general revenue, averaging more than 77 per cent for the entire period.

Of the other three taxes in use during this period, the stamp tax was the most important, contributing from 4 to 8 per cent of total revenues. The property (land) tax and the license tax each averaged about 2 per cent for the period. The relative unimportance of these three sources is explained, in large part, by the fact that they were levied and collected only in the Federal Capital and the National Territories. For the same reason, the stamp tax stands out among the three because a large percentage of the country's business has always been transacted in and through Buenos Aires.[3]

In the second period, 1931-1943, a number of significant changes were made in the Argentine tax system. The essential reforms of the early 1930's can be summarized as follows:

1. Unification of all excise taxes. An agreement was reached between the federal and the provincial governments whereby the provincial governments, in exchange for participation in the revenues, agreed to refrain from introducing such taxes during the whole period of the law which was passed to legalize this agreement, or prior to 1954.

2. Creation of a new federal income tax in the form of a schedular tax and a surtax on the total income. This tax was first introduced as an emergency measure for two years only, in accord with the Constitution. In 1934, however, Congress extended the tax for another ten years, giving it a permanent character for all practical purposes. This decision was made by Congress without entering into an agreement with the Provinces, and it was considered unconstitutional by most Argentine lawyers. However, all Provinces were given a share in the revenues produced by the income tax. They incurred no administrative costs and

[2] Mario Pugliese, "Problems of Public Finance in the Argentine Republic," *Taxes*, XVIII (August, 1940), p. 494.

[3] The inheritance tax was first levied in 1912 and the proceeds were earmarked for the National Council of Education to finance primary education in the Federal Capital and the National Territories. Thus, revenue from this source did not appear in general revenue resources until 1935. Secondary and higher education is provided by the National Government, but the Provinces assume responsibility for primary education in their respective jurisdictions. They levy and collect inheritance taxes for this express purpose. *Recopilación de Leyes Usuales de la República Argentina con sus Correspondientes Decretos Reglamentarios*, J. Lajouane y Cía editors nueva edicion (Buenos Aires: Libreria Nacional, 1927), p. 547; and Ministerio de Hacienda de la Nación, *Memoria*, 1935 (Buenos Aires: Geronimo J. Pesce y Cía, 1936), Tomo I, p. 33.

TABLE 1

CONTRIBUTIONS OF MAJOR TAXES TO GENERAL REVENUE OF ARGENTINE NATIONAL GOVERNMENT, 1892–1950

(Percentage of Total Revenue)

Year	Total Revenue †	Customs and Port Fees	Internal Taxes	Licenses	Stamp Taxes	Land Tax	Sales	Income	Inheritance	Excess Profits	Capital Gains
	(millions of pesos)	%	%	%	%	%	%	%	%	%	%
1892	84.2	81	5	2	5	1	..	..	..	..	..
1895	95.6	70	8	2	6	1	..	..	..	..	..
1900	145.7	55	25	1	5	1	..	..	..	..	..
1905	204.3	57	17	1	5	1	..	..	..	..	..
1910	302.1	63	16	*	5	1	..	..	..	..	..
1915	265.4	41	22	2	4	2	..	..	..	..	..
1920	480.2	63	20	2	6	2	..	..	..	..	..
1925	583.3	56	19	3	8	6	..	..	..	..	..
1930	652.2	54	17	4	8	6	..	..	..	..	..
1935	1,057.2	31	18	2	6	4	2	7	1	..	..
1940	933.8	29	18	*	7	3	4	14	2	..	..
1942	1,047.6	19	26	*	7	3	4	19	3	..	..
1944	1,299.5	9	17	*	7	3	5	26	3	4	..
1946	2,013.2	14	20	*	7	3	6	24	2	4	1
1948	3,803.1	14	13	*	6	3	4	22	2	6	5
1950‡	4,870.0	10	10	*	4	1	17	20	2	5	5

* Less than 0.5 per cent.

† Total includes minor taxes, fees, receipts from Posts and Telecommunications, debt service payments of various Provinces, and others not shown in table.

‡ Estimated.

Source: Ernest F. Patterson, "The Finances of the National Government of Argentine" (Unpublished Ph.D. dissertation, Department of Economics, University of Texas, 1950), Appendix B, Table B-1.

no risk of fiscal competition with each other. The decision was tacitly accepted, therefore, and the power to levy an income tax became the exclusive prerogative of the federal government.

3. Creation of a new federal tax on commercial transactions. In 1934 the transactions tax was changed to a sales tax on the business of manufacturers and importers.

4. Creation of a federal tax on gasoline and other taxes and fees of lesser importance. Customs duties were increased by 10 per cent and petroleum royalties and mining fees were stepped up to make them a significant source of revenue.

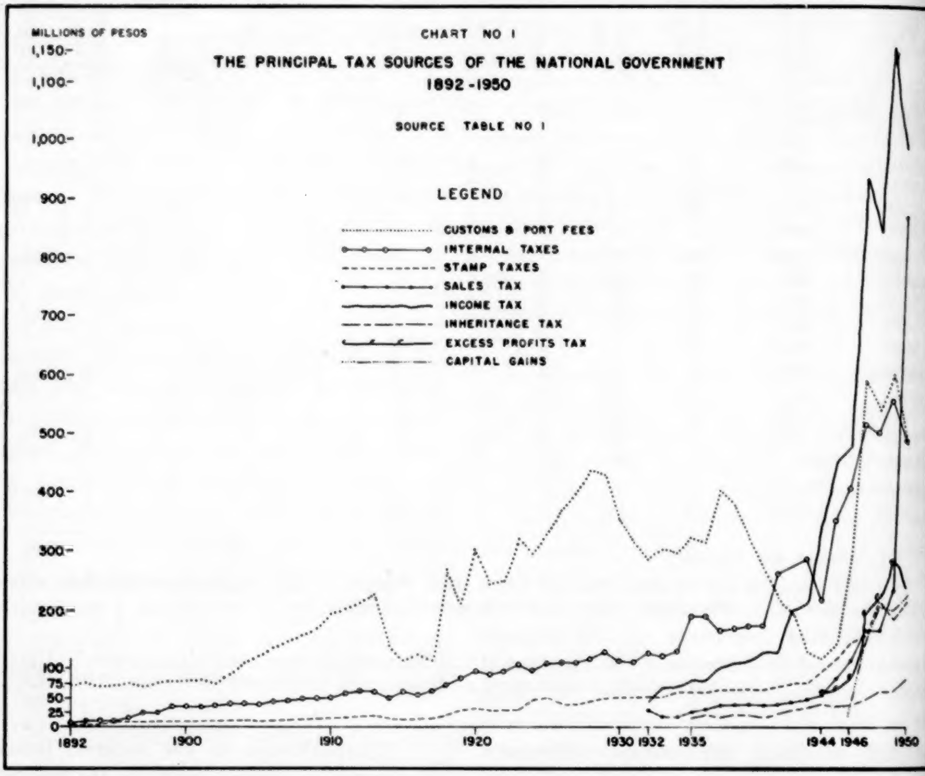
5. Establishment of the national lottery as a source of general revenues for the National Government.

6. Establishment of control of the foreign exchange market. By this privilege the government—currently through the Central Bank—purchased the largest part of foreign exchange from exporters and sold it to importers at a profit. These profits were used largely to defray the costs of the government's price support programs, agricultural development programs, and repatriation of the external debt.

These reforms, as was expected, produced a significant change in the rela-

tive importance of different taxes. In 1930, 54 per cent of general revenues came from customs collections. By 1933 this percentage had dropped to 40 per cent and by 1944 to 9 per cent.

are in reality impositions that affect consumption directly or indirectly. . . . Our tax system, in spite of the important incorporation of the Income tax, continues to suffer from . . . lack of stability, lack of elasticity, and above all, lack of equity.[4]



The decline is explained in part by an absolute reduction (60 per cent) in customs collections during the depression and World War II; however, it is also explained by the increasing yield of the new taxes instituted during and after 1931, particularly sales and income taxes. The fraction of revenue contributed by the income tax, for example, increased from 6 per cent in 1932 to 20 per cent in 1943.

Despite these important reforms, it could still be said in 1943 that:

. . . various of the new taxes now in force

The most recent period of tax reform began following the "Revolution of 1943." The avowed, primary objective of reform since 1944 has been to make the tax system more progressive, as was intimated by the foregoing criticism. These reforms took three directions: (1) imposition of new taxes that were mainly of a "direct" kind—the most important of these being the excess profits tax (impuesto a los beneficios

[4] Carlos Luzzetti, "Un Cuarto de Siglo de Finanzas Nacionales," *Revista de Economía Argentina*, Año XXV, Tomo XXXVI (Junio, 1943), p. 267.

extraordinarios) and the capital gains tax (impuesto a las ganacias eventuales); (2) revisions of existing taxes, primarily the income tax, which lessened the tax burden on lower income groups and increased it on high income groups; and (3) improvement and modernization of the methods by which the taxes are collected.

With this general picture of the evolution and present structure of the Argentine tax system, it is possible to turn to a description of each of the principal taxes currently being used.

Customs

Two general features of the Argentine customs duties should be noted at the outset. First, they have been designed chiefly to raise revenue rather than to protect home industry. Second, in contrast to most other Latin American countries, Argentina has not used export duties to any great extent.

The development of the Argentine tariff laws has followed much the same pattern as in the United States, and the general features are very similar. That is to say, the first duties—entirely *ad valorem* up to 1882—were relatively low, but in time the rates were increased to quite high levels and the list of taxed commodities was greatly expanded. The practice of establishing schedules of rates (begun in this country in 1846 with the Walker Tariff Act) was not adopted in Argentina until 1905.[5]

Several special features of Argentine customs are worth comment. First, each of the tariff laws includes the provision that duties are to be liquidated on the basis of a schedule of officially fixed prices (Tarifa de Avalúos), " formed on the base of the true price of the articles on deposit, in case of those of importation, and on the base of the market price at time of shipment for those of exportation." [6] Presumably these prices or values were to have been set annually by the Executive Power. This was not done, however, and they soon bore little relation to the real price of the commodity. This situation was the subject of much criticism in Argentina and several attempts have been made to reform and revise the Tarifa de Avalúos. The latest was in 1941 when an *ad hoc* committee was appointed by the President for the express purpose of revising the schedule of official prices. The committee made its report in 1946,[7] and the institution of its recommendations is still in progress.

A second interesting aspect of the Argentine customs is the extensive use of the Executive Decree. By terms of the Tariff Law of 1923, the President was authorized to increase duties by as much as one-half, or to levy new duties —up to a maxium of 15 per cent *ad valorem*—on imports from countries which did not grant most-favored-nation treatment to Argentine products. The 1923 law likewise empowered the President, without legislative approval, to reduce the minimum import duties by not more than one-half, in return for equivalent concessions in commercial agreements with other na-

[5] Augusto da Rocha, *Leyes Nacionales Clasificadas y sus Decretos Reglamentarios* (Buenos Aires: J. Belmonte, 1936), Tomo V, 3ª Parte, pp. 325-32.

[6] *Ibid.*, p. 175.

[7] See Ministerio de Relaciones Exteriores y Culto, *Informaciones Argentinas* No. 57 (Octubre 15, 1941), p. 10; and *Memoria del Departamento de Hacienda*, 1946 (Buenos Aires: Geronimo J. Pesce y Cía, 1947), Tomo II, p. 245.

tions.[8] In 1931 the Executive Power was authorized to impose new or higher import duties to prevent designated types of "dumping."[9] In 1939 he was authorized to suspend the several "additional duties" on certain designated articles of prime necessity.[10] In 1941 authorization was granted to raise the tariffs when it was deemed necessary to protect Argentine industry, and the following year the President was given power to apply a flexible tax on exports:

(a) when it is deemed desirable to encourage an increase in the scale of production of articles which are at present being produced on a relatively small scale in relation to their market possibilities; and (b) when it can be shown that the cost of production has increased by more than 20 per cent.[11]

Internal Taxes

From the standpoint of yield, one of the most important taxes has been the internal taxes. These are excise taxes similar, for example, to our federal tax on cigarettes. The first federal internal tax law was enacted in 1891. The Provinces were already levying internal taxes, since they were not among the tax sources specially delegated to the central government, or prohibited to the Provinces. Eventually there were fifteen different political jurisdictions imposing these taxes—frequently on the same items. In 1924 an Argentine economist summed up the state of affairs as follows:

. . . The prosperous state of the internal revenue is now menaced by a financial anomaly which, as will be made clear, may turn into a political conflict of the most grave character. The two systems (Federal and Provincial) are beginning to clash in every phase of their economy and application. For example, the beer producing States do not tax beer, but wine. The wine producing States, on the other hand, impose a heavier rate on beer than on wine. Moreover, those of identical production, the wine-producing, which means nearly all the Provinces, impose differential rates, each taxing the wine of the other Provinces at a higher rate than their own. . . . The quality of the taxed article also originates conflicts. In the case of wine, for example, to constitute genuineness some local laws require different qualities so that a genuine wine suitable for consumption in one State is not such in another.

But most serious of all are the *ad valorem* imposts on tobacco, playing cards, perfumery, etc. Thus, by the National law a package of cigarettes which sells at ten centavos, including the tax of three and one-half centavos, is again taxed two centavos by the local law, so that the retail dealer, in the latter case, cannot sell the package at ten centavos, but must charge twelve or fifteen, in this way destroying the taxable basis, which is prohibited or penalized by other regulations. But the conflict

[8] da Rocha, *op. cit.*, pp. 367-8.

[9] "El Decreto Argentino de Antidumping," *Revista de Economía Argentina*, Año 14, Tomo XXVII (Septiembre, 1931), pp. 213-4.

[10] "Argentine Economic Controls and Commercial Policy," *Comments on Argentine Trade*, 25 (March, 1946), p. 35.

[11] "A Comprehensive Plan of Financial Regimentation," *Review of the River Plate*, XCII (June 12, 1942), p. 19. The tax was to be levied against export items which had benefited from war prices, and was to be based on average quotations for a basic period, 1937-39, plus 20 per cent for increased cost of production. The difference between the total thus obtained and the current export quotations, as indicated by the export bills that had to be presented when the exchange was sold to the government, would be paid to the government. This tax, which was only one part of the "Comprehensive Plan," was expected to be used in such a manner as to force substitution of the production of relatively unsalable products for others which would have a higher internal-consumption or export demand.

does not end here, as may be seen. The increase in price caused by the local impost leads as a consequence to the imposition of a surtax, which carries the article a step farther in the scale of local prices, and to yet another surtax, and so on endlessly.[12]

To remedy this situation, in 1934 the Executive Power sent a bill to Congress which made it possible for the Provinces to enter into agreements with the National Government whereby they would repeal all internal excise taxes on products taxed under federal law. All such taxes would be collected by the National Government. In return for signing the agreement, the Provinces were to receive a part of the collections made by the National Government. The Law, No. 12,139, was passed in December, 1934, and immediately all Provinces, except three (these three agreed at a later date) signed agreements to adhere to the provisions of the law. In order to secure enough money to make the payments to the Provinces, the National Government raised the rates on the products included in the law; in spite of this, the Treasury Department calculated that in 1934 the total per capita tax paid under the federal law and all the provincial laws was 17.32 pesos, while under the Unified Internal Taxes law the tax would be only 15.11 pesos.[13]

Table 2 gives the principal commodities which were taxed under the internal tax law, previous to the most recent modifications. These modifications are embodied in Law No. 13,648

TABLE 2

PRINCIPAL ARTICLES AFFECTED BY THE INTERNAL TAX AND THEIR RATES

Article	Minimum Tax (Pesos)	Maximum Tax (Pesos)
Cigarettes, nationally produced, package of ten	0.04	0.305
Cigars, nationally produced, each one	0.0264	0.108
Tobacco, nationally produced, per kilogram	2.40	13.0
Alcohol, industrial, per liter	0.015	....
Alcohol, from fruits, per liter	0.01	....
Alcoholic beverages, per liter	0.125	0.50
Matches, per package of 35..	0.0225	....
Lighters, each one	3.00	6.00
Beer, per liter	0.05	0.08
Wines and ciders, per liter ..	0.05	1.00
Toilet articles, per 100 grams	0.01	2.50
Mineral waters, per liter	0.05	0.10
Specialized medicines, per container	0.02	0.10
Insurance and national capitalization, per cent of premium	0.50	1.30
Gasoline and oil, per liter ...	0.06	0.10
Automobile tires, per kilogram	2.00	....
Silks, national and imported	0.30	1.00
Playing cards, per set	0.50	2.00
Sugar, national and imported, per kilogram	0.02	....
Suntan objects	5% on sale price	....

Source: Carlos A. Warren, *Emancipación Económica Americana,* Tomo I, 572.

(November, 1949), which provides that the internal tax will apply on the net sale price of the commodity as it appears on the invoice or equivalent document drawn up by the person obliged to pay the tax. The following examples suggest the level of effective rates: matches, 45 per cent; beer, 15 per cent; wines, 8 per cent; ciders, 10 per cent; toilet articles, 15 per cent; suntan objects, 20 per cent; and silk, 10 per cent.[14]

[12] José M. Ahumada, "The Fiscal System of Argentina and its Problems," *The Economic World,* (n. s.) XXVII (March 22, 1924), p. 413. See also, *Memoria del Departamento de Hacienda,* 1934 (Buenos Aires: Geronimo J. Pesce y Cía, 1935), Tomo I, Capitula IV, "Unificación de los Impuestos Internos," pp. 89-116.

[13] *Memoria del Departamento de Hacienda, op. cit.,* p. 114.

[14] Ministerio de Hacienda de la Nación, *Boletín,* Año IV, No. 179 (Noviembre 5, 1949), pp. 2405-12.

Sales Tax

The next taxes to be considered are those that were instituted after 1930. A transactions tax was one of the first, and was imposed by Decree of the Provisional Government in 1931. The tax " fell on all sales of commodities between merchants, or those effected through merchants to individuals in all the territory of the Argentine Nation." [15]

The following businesses were exempt from payment of the tax: those whose volume of sales in the last year were less than 25,000 pesos; smaller bakeries, meat markets, and dairies; public utility companies; newspaper and periodical publishers; and dealers in cereals, meat, and fruits of the country in the internal market, which had not undergone any processing.[16]

Law No. 11,587 (June 30, 1932), which ratified the provisions of the Decree, made some significant changes. For one thing, it broadened the tax base, extending it to " all commercial transactions effectuated by merchants, or between merchants and individuals through the territory of the Argentine Nation." The original Decree had taxed only " sales." The law provided that the tax " will apply on the net total volume of the operations realized." Additional businesses were exempt including co-operative societies, banks, and insurance and capitalization companies. Mortgage loans and sales of national, provincial, or municipal bonds were also excluded. The rate was fixed at 3 per cent for national producers and industries in their direct sales or by means of exclusive consignees, and 5 per cent for all other transactions.[17]

The " transactions " tax with its inevitable cumulative effects was highly criticized. Although the Executive Power secured a modification in January, 1934, whereby the tax exempted transactions of small businesses—" those that resell commodities to the retail or directly to the consumer, in the same state in which they acquire them in the internal market " [18]—the tax continued to be unpopular.

When the law expired in 1934 the Executive sent to Congress a new law which repealed the tax on transactions and replaced it with one on sales. This bill established a tax on the sales of commodities, fruits, and products, realized in all the territory of the Argentine nation, in a form that falls on only one of the steps in the sale of each commodity. The tax was to apply on the net sale price as shown on the invoice or equivalent document, given by the persons obliged to pay the tax. Net sale price was defined as the price of the commodity that resulted after deducting cash discounts and the like, in accordance with the customs of the market. The following were made subject to the tax: national producers and manufacturers, for the tax corresponding to the sale of commodities of their production or manufacture; importers, for the tax arising from the sale of imported commodities for their own account or for the account of others; exporters, for the tax arising from the exportation of commodities on their own account or for the account of others. Essentially the same exemptions

[15] Enrique Jorge Rieg, *El Impuesto a las Ventas* (Buenos Aires: Editorial Ideas, 1947), p. 46.

[16] *Ibid.*, p. 46.

[17] da Rocha, *op. cit.*, Tomo VII, 5ª Parte, p. 381.

[18] Reig, *op. cit.*, p. 49.

were retained as existed under the "transactions" tax. Finally, the rate was established at three mills (3/10 of 1 per cent) for products or commodities sold or consigned to the exterior, and at 1.25 per cent for sales in the internal market.[19]

The law provided that proceeds of the tax would be distributed between the National Administration and the Federal Capital and Provinces. Until 1938 the division was 82.5 per cent for the National Government and 17.5 per cent for the Provinces and Federal Capital. Revenue allotted to the Provinces was distributed among them according to the following formula:

(a) 30 per cent in accordance with the population of the entity as shown by the last official census;

(b) 30 per cent in accordance with the amount of the entity's budget expenditures of the previous year;

(c) 30 per cent in accordance with the resources received by each entity during each preceding year;

(d) 10 per cent in accordance with the sales tax collections within the jurisdiction of each Province in the preceding year.

The participation of the Federal Capital was determined by applying the indices established in (a), (b), and (c) above.[20]

This division remained in force until 1947 when the proportions were changed to 79 per cent for the Nation, and 21 per cent for the Provinces and Federal Capital. Nineteen per cent of the Provincial and Federal Capital share was distributed in accordance with the provisions given above, but the remaining 2 per cent was to be distributed in inverse proportion to the population assigned to the respective entities by the last official census. The latter provision was included because the Province of Buenos Aires and the Federal Capital were thought to be receiving more than their rightful share because of the concentration of population in these areas.[21]

At present the sales tax is national in scope and is levied on the sale or transfer of ownership of merchandise, commodities, and products in the domestic market, as well as those sold or consigned for export. In 1949 the rate was raised to 8 per cent.[22]

Income Tax

By all odds, the most important addition to the tax system of Argentina has been the income tax, instituted by Decree of the Provisional Government on January 19, 1932. The Decree limited the duration of the tax to two years in order to make it constitutional. All incomes derived from Argentine source, in favor of Argentines or foreigners, resident or not, were made subject to the tax.[23]

The tax was drafted as a schedular tax imposed on four categories of income. Category one, land income, included all income derived from the exploitation of real property situated in rural and urban areas. Income from urban property, whether inhabited by the owner or not, and from rural property if not inhabited by the owner, was taxed at the normal rate of 6 per cent of the rent annually received. To pro-

19 *Ibid.*, pp. 288-91, and 387.

20 *Ibid.*, pp. 294-5.

21 Ministerio de Hacienda de la Nación, *Boletin*, Año II, No. 47 (Abril 12, 1947), pp. 130-1.

22 *International Reference Service*, VII, No. 9 (April, 1950), p. 7.

23 *Revista de Economía Argentina*, Año 14, Tomo XXVIII (Febrero, 1932), p. 150.

vide a standard for owner-occupants, it was presumed that income was equal to 5 per cent of the fiscal valuation, except when proved to the contrary by the owner. Income derived from rural property was taxed at a rate of 4 per cent if the fiscal valuation exceeded 25,000 pesos, but it was fully tax exempt if the property was valued at less than this amount.

The second category included income from intangible investments such as securities and royalties and was taxed at 6 per cent of the total income, less certain deductions.

Income from commerce and industry formed the third category and was taxed at 5 per cent. Business net income was defined as gross income less deductions such as interest, taxes and fees other than those that were shifted, bad debt losses, depreciation, ordinary business expenses other than the salary of the taxpayer, and extraordinary uninsured losses. The reporting problem was simplified for small businesses, those with an annual sales volume of less than 50,000 pesos, by the assumption that net profits equalled 10 per cent of sales.

Earned income comprised the fourth category. Such income was divided between (1) salaries, wages, etc., and (2) income from the exercise of a profession, and was taxed progressively. Wages and salaries were taxed at rates progressing from ½ per cent on a monthly income of 175 pesos to 4 per cent on monthly incomes above 2,000 pesos. Members of the professions were taxed on the basis of "presumed monthly incomes," which were secured by multiplying the monthly rent which the person paid for his office by a coefficient ranging from 2½ per cent to 4 per cent. Thus, if a lawyer paid 70 pesos per month rent on his office, it was presumed that his monthly income was 175 pesos. The annual tax in this case was fixed at 10.50 pesos, or at a slightly higher rate than that applicable to wages and salaries.

In addition to the above tax, all natural persons with annual incomes of more than 25,000 pesos were subject to a progressive surtax rate. The highest surtax rate was 7 per cent on income in excess of 250,000 pesos, the total tax not to exceed 17,500 pesos. The taxpayer could deduct interest paid on debts if said interest had not already been deducted when paying the basic rate. Interest and losses suffered during the year on any commercial or industrial investment were deductible.[24]

Since 1932, of course, many changes have been made in the law. Payment of the income tax at present is governed by Law No. 11,682, 1947 text as amended by Laws No. 13,647/50, No. 13,925/50, and regulated by Decree No. 23,586/50. The following paragraphs describe the most important features of that law.

All income of Argentine origin is taxed and is still classified under the four headings mentioned above. Allowable deductions in computing taxable income are, in general, those customarily regarded as expenses of securing and maintaining income. The deduction of straight life insurance premiums up to 5,000 pesos and certain types of charitable donations are worth mentioning, however, as is the one-year carry-forward of losses.

In addition, special deductions are established for each separate income

[24] The information about the first income tax was taken from da Rocha, *op. cit.*, Tomo VII, 5ª Parte, pp. 240-2 and *Revista de Economia Argentina*, Año 14, Tomo XXVII (Febrero, 1932), pp. 150-1.

category. Class 1 income (income from real estate) receivers, for example, are allowed to deduct the cost of maintaining the property, if supported by vouchers. Class 2 income recipients are permitted a 25 per cent depletion allowance against income from depletable sources. Income coming under category 3—business or industrial income—is charged with normal business expenses including additions to reserves for employees' dismissal and contributions for employee welfare and bonus plans. The only special deduction allowed for class 4 income is the legally required contribution to pension and retirement funds.

Individuals residing in Argentina and deriving from Argentine sources income in excess of the minimum allowable for personal exemptions and family allowances are required by law to file an income tax return. Personal exemptions are set at 3,600 pesos on class 1 or 2 income, and 6,000 pesos for class 3 or 4. If the individual obtains class 1 or 2 income, in addition to class 3 or 4, the personal exemption will range from 3,600 pesos to 6,000 pesos, depending on which class accounts for the greater percentage of the total (the larger the percentage coming from 3 or 4, the higher the exemption). Finally, " heads of families " are granted a further personal exemption of 1,500 pesos. Thus maximum personal exemptions may be summarized as follows:

Class of Income	Single Person	Head of Family
Category 1 or 2	3,600	4,100
Category 3 or 4	6,000	7,500

Source: Ley No. 13,925 in *Anales de Legislacion Argentina,* Vol. X-A. Adapted from Article 20, p. 73.

In addition to the personal exemptions, dependent exemptions of 1,500 pesos for spouse and 1,200 pesos for each dependent are allowed.

After all allowable deductions, net taxable income is subject to a normal tax of 7 per cent, and incomes which exceed 5,000 pesos are subject to the surtax rates shown in Table 3. In addition, individuals who habitually reside abroad pay an additional tax of 30 per cent on income from agriculture and stock raising (class 1).

TABLE 3

SURTAX RATES ON PERSONAL INCOME

Tax Bracket	Bracket Tax Rate
5,000– 10,000	2%
10,000– 15,000	5%
15,000– 20,000	8%
20,000– 25,000	11%
25,000– 50,000	14%
50,000– 75,000	17%
75,000– 100,000	19%
100,000– 150,000	21%
150,000– 200,000	23%
200,000– 250,000	25%
250,000– 500,000	27%
500,000– 750,000	29%
750,000–1,000,000	31%
1,000,000 and over	33%

Source: *Anales de Legislacion Argentina,* Vol. X-A, p. 74.

The normal tax and surtax, if applicable, are levied on the sum of all incomes after deducting the personal and dependent exemptions. The maximum rate any individual could pay is 38.3 per cent on category 1 and 2 income over 4,000,000 pesos. Some idea of the aggregate current burden of the personal income tax can be secured from Table 4 below. This table assumes a net income of 20,000 pesos under three different situations: (1) class 1 income received by single person; (2) class 4 income received by single person; and (3) class 4 income received by " head of family " with wife and three dependent children.

TABLE 4

ILLUSTRATIVE INCOME TAX COMPUTATIONS, 1952

	Class 1 Income Single person	Class 4 Income Single person	Class 4 Income Head of family (4 dependents)
Net income	20,000 pesos	20,000 pesos	20,000 pesos
Personal exemption	3,600	6,000	7,500
Dependent "	0	0	5,100
Net taxable income	16,400	14,000	7,400
Normal tax (7%)	1,148	980	518
Surtax	462	300	48
Total tax	1,610	1,180	566
Tax as % of income	8%	5.9%	2.8%

For comparison with the United States, pesos can be converted at approximately 25 cents per peso. It should be noted that the purchasing power of the peso for the Argentine is considerably less than that of the dollar for the American. The "cost-of-living" index for Argentina in December, 1951, was 274 (1948 = 100), while for the United States it was 110.[25]

The tax on domestic corporations and foreign corporations with permanent establishments in Argentina is 15 per cent of net earnings or of dividends declared, whichever is greater. An additional tax of 5 per cent is levied on dividends remitted abroad. Absentee corporations which derive income from farming and/or ranching are subject to an additional charge of 30 per cent of the normal corporate tax.[26]

As is true of all nation-wide taxes collected by the central government, the proceeds from the income tax are distributed among the National Government, the Provinces, and the Federal Capital. This practice was not adopted in the case of the income tax until 1935, but once instituted, collections were distributed annually in the following proportions: 82.5 per cent to the National Government and 17.5 per cent to the Federal Capital and Provinces.[27] This move was undoubtedly made to gain provincial support for the new tax since provincial authorities had viewed it with disfavor and many had refused to cooperate with the National Administration in making collections.[28] In 1949 the participations were changed to 79 per cent and 21 per cent by the same decree which changed the percentages applying to the distribution of the sales tax proceeds.

Excess Profits and Capital Gains Taxes

With the exception of the income tax, the two most important additions to the Argentine tax system have been the excess profits and capital gains

[25] United Nations, *Monthly Bulletin of Statistics*, VI (June, 1952), pp. 128 and 135.

[26] Ministerio de Hacienda de la Nación, *Impuestos a los Réditos y a los Beneficios Eventuales, passim.*

[27] da Rocha, *op. cit.*, Tomo VII, 5ª Parte, p. 384.

[28] "There has been considerable difficulty in collecting the income tax anywhere except in the City and Province of Buenos Aires. Throughout the rest of the Republic the tax has been treated more or less as a dead letter, with the tacit consent of the Provincial authorities." *The Economist* (London), CXVII (August 19, 1933), p. 368.

taxes. The first was established by Executive Decree (No. 18,230 of December 31, 1943). It "establishes, transitorily, during the term of three years, a tax on the excess profits originating in the exercise of commerce, industry, mining, farming, ranching, or whatever other activity, which involves the transformation or habitual disposition of goods and services." [29]

Some significant changes were made in the law in 1944 (Decree No. 21,702). Under this act, excess profits are defined as all profits which exceed 12 per cent of the capital and free reserves in the year of the application of the tax. (Under the original decree excess profits were calculated by deducting an earned income credit equal to 1938 or 1939 income.) Profits for the year were declared to be the taxable profits established for income tax purposes, with various technical modifications:

(a) For the purposes of this tax, limited liability companies may deduct the fees paid to directors up to 8% of the companies' profits; if the sums actually paid are less than 8%, they shall deduct only the sums actually paid.

(b) Fees, etc. paid in respect to technical and financial advice from abroad when they are included in the calculations, shall only be deducted so long as they do not exceed 1% of the taxable profits of the company.

(c) All firms except corporations will be able to deduct the sum of 300 pesos per month for each partner who is actually employed in the country in the service of the company. This deduction will apply to the working partners in cases of limited partnerships, but not to the silent partners.

(d) Profits or losses resulting from participation in other taxed concerns will not be computed for the purpose of determining the taxable profit.

(e) When there exist investments in fixed assets made later than January 1, 1940—except immovable property—there will be permitted the deduction of an additional amount equal to the amount of the technical amortizations authorized for purpose of calculating the income tax.

(f) Excess profits tax may be deducted for the liquidation of the income tax, but not for the liquidation of the present tax.

The income tax liability will not be deducted from the liquidation of the present tax, but instead there will be admitted without any distinction an additional deduction of 10% of the profit of the year, adjusted in accordance with the norms and rules of this Decree.[30]

After determining "excess profits," the law allows an additional deduction of 20,000 pesos. The tax is calculated on the balance in accordance with the following:

10% on the amount of the total taxable excess profits up to 5% of the capital and free reserves, plus

15% on the amount of the total taxable excess profits between 5% and 10% of the capital and free reserves, plus

20% on the amount of the total taxable excess profits between 10% and 15% of the capital and free reserve, plus

25% on the amount of the total taxable excess profits between 15% and 20% of the capital and free reserves, plus

30% of the amount of the total taxable excess profits that exceed 20% of the capital and free reserves.[31]

[29] Ministerio de Hacienda de la Nación, *Boletin*, I, No. 6 (Mayo 4, 1946), p. 563.

[30] *Ibid.*, p. 569.

[31] *Ibid.*, p. 566.

The capital gains tax, established in May, 1946, was designed to tax all profits that were not then taxed under the income tax law. Thus Article 1 stated:

All the profits obtained after January 1, 1946, by persons of physical or ideal existence, or undivided inheritances, derived from Argentine source and not taxed by the Income Tax Law, remain subject to the national emergency tax that the present Decree-Law establishes. This tax will be in force until December 31, 1955.[32]

The distinction between profits subject to the income tax and those considered to be fortuitous, and hence not subject to the tax, rested upon the regularity of receipt. Taxable income included all those accruals which were recurring or were likely to recur. Other gains were considered an increase of capital, and as such exempt from the income tax. Decree No. 14,342 provided that an increase in capital or profits had to take place only once in order for the capital gains tax to be applicable, regardless of the origin of the increase or profits.

It was provided that the tax would be applicable on the "net taxable profit" determined in the following manner. From the sales price these items could be deducted: the purchase price; the value of improvements (provided they had been made for the purpose of preserving or increasing the value of the asset sold); and indispensable expenses (such as taxes, dues, and any other expenditures imposed by public authorities). These deductions were not allowed if they had been included as deductions in the taxpayer's income tax returns.[33]

The original decree provided for exemption of 4,000 pesos per annum before the tax applied. This exemption could benefit several persons owning a property jointly when transferred to a third person. Thus, if a property were owned by four persons and sold for 15,000 pesos net profit, no tax would be paid since the sale would not produce a profit of 4,000 pesos for each of the owners. This provision has since been changed and now provides that 6,000 pesos per annum is exempt; if the profit is obtained by more than one person, however, "each one of them only will have the right to deduct in his sworn declaration a proportional part of the 6,000 pesos in conformity with the participation that each one has in the taxable profit obtained from the operation." [34]

The rate of the tax was fixed at 20 per cent in the first decree and remained at this figure until 1950. At that time, changes in the law provided that profits made on the purchase and sale of real estate would henceforth be subject only to the capital gains tax and not the income tax. The rate was increased from 20 per cent to 40 per cent, provided that the period of time between the purchase and the sale of the respective property was less than one year. Thereafter, the tax was reduced by 1 per cent for each month in excess of one year to a minimum of the original rate of 20 per cent.[35]

[32] *Memoria del Departamento de Hacienda,* 1946 (Buenos Aires: Geronimo J. Pesce y Cía, 1947), Tomo II, Segunda Parte, p. 847.

[33] *Ibid.*, p. 849.

[34] Ministerio de Hacienda de la Nación, *Impuestos a los Réditos y a los Beneficios Eventuales*, p. 145.

[35] Ministerio de Hacienda de la Nación, *Boletín*, IV, No. 179 (Noviembre 5, 1949), p. 2400.

Minor Taxes

The foregoing are the most important taxes and sources of general revenue of the Argentine National Government. Other sources include certain minor taxes, fees, and, since 1931, the profits made from the government's control of the foreign exchange market. Three of the minor taxes—stamp, license, and property—have been used by the National Government almost continuously from the beginning of the Republic's history. They have been, and continue to be, levied by the National Government in the Federal Capital and the National Territories only. All the Provinces levy these taxes in their respective jurisdictions.

At first only a relatively few commercial and business transactions had to bear a special stamp or be transacted on stamped paper, and the rates were low. Both the number of items taxed, and the rates, have been increased, however, until today practically all commercial transactions and commercial and legal documents have to bear a stamp.

A license tax is levied by the National Government on " all individuals who exercise in the Capital of the Republic a branch of commerce, industry, or a profession, and in the Territories of the Nation." [36] In other words, the tax constitutes a permit to do business in the Federal Capital and the National Territories similar to licenses required by cities in the United States, and it is payable annually. The cost of the license depends upon the type of business, and, in some cases, upon the annual volume of business transacted.[37]

[36] da Rocha, *op. cit.*, Tomo VII, 5ª Parte, p. 3.

[37] Ministerio de Hacienda de la Nación, *Boletin*, Año III, No. 127 (Noviembre 6, 1948), pp. 2324-6.

The National Government levies an annual property tax of six mills (3/5 of 1 per cent) on the total assessed valuation of land, buildings, and improvements of all privately owned real property situated in the Federal Capital and the National Territories. The valuation of the land is based on the last sale price obtained in the preceding three years, or, in the absence of a sale, on the average sale price of adjacent or nearby properties during the same period. Buildings and improvements are assessed at their actual value. There is provision for a general revaluation of the properties every ten years.[38]

The most recent development in the property tax regime is the proposal to make use of the tax to encourage small landholders and to break up the *latifundia* system of land ownership (large landed estates) which plagues Argentina. The first Conference of Finance Ministers held in 1946 passed a Resolution stating that whereas:

> . . . (The Property tax) can be used as an adequate means for combatting the *latifundia* in the cases in which it is uneconomic, since it permits taxing in progressive form the property base that does not fulfill the social ends that justify it, tending thus to the division of the land.
>
> It is recommended:
>
> 1) To exempt, totally or partially, the small property occupied by its owner.
>
> 3) To establish a progressive tax for the uncultivated lands.
>
> 4) To establish a progressive tax on the *latifundias*. . . .[39]

Attempts were made in 1947 to translate these recommendations into

[38] *Recopilación de Leyes Usuales de la República Argentina*, p. 1048.

[39] *Memoria del Departamento de Hacienda*, 1946 (Buenos Aires: Geronimo J. Pesce y Cía, 1947), Tomo II, Primera Parte, p. 700.

TABLE 5

RESOURCES COLLECTED BY THE NATION WITH SPECIAL DESTINATION, 1945–1946

(Thousands of pesos)

Tax	1945	1946
Tax on gasoline *	80,000	75,000
Tax on aviation type gasoline †	.....	1,200
Tax on lubricants *	5,500	6,200
Tax on other combustibles *	2,200	5,000
Three per cent contribution on exploitation of railroads *	1,530	1,530
$0.001 per liter tax on wine ‡	7,500	9,200
Mobile tax on yerba mate §	6,600	.....
$0.02 per quintal of wheat exported ‖	700	700
Range products transfer contribution **	16,500	16,500
Contributions of employers with four or more workers ††	.....	7,200
Tax on professional sports ‡‡	100	150
Additional tax on gasoline *	.....	45,000
Total	120,630	174,280

* To National Highway Administration.

† To General Office of Civil Aeronautics.

‡ To Wine Culture Office.

§ To Yerba Mate Office.

‖ To National Grain and Elevator Commission.

** To National Meat Board.

†† To National Commission of Apprenticeship and Professional Orientation.

‡‡ To National Honorary Commission for Development of Sports and Office of Administration of the Minister of War.

Sources: 1945—*Presupuesto General de la Nación para el Ejercicio de 1945,* CXCV. 1946—*Presupuesto General de la Nación para el Ejercicio de 1946,* 41–2.

concrete parts of the tax regime when it was provided that property situated in the Federal Capital District with a valuation of 20,000 pesos or less and occupied by an owner who possessed no other property would be exempted from the property tax. Further, unoccupied lands were made subject to an " additional " tax of three mills per thousand on their valuation.[40]

[40] Ministerio de Hacienda de la Nación, *Boletin,* Año II, No. 55 (Junio 21, 1947), p. 824.

To complete the picture of the Argentine tax system, we should mention the taxes with " special destination," or those specifically " earmarked " for a specific agency or purpose. These taxes are given in Table 5, together with the agency which receives the proceeds. Thus the receipts from the " additional " tax on gasoline and lubricants go to the national Highway Administration. The " additional " tax on wine is earmarked for the special benefit of the Wine Culture Office. The tax on exported wheat produces income for the National Grain and Elevator Commission, and so on.

Conclusion

Although this description of the development and nature of the Argentine national tax system indicates that many improvements have been made in the system—the principal one being the change from a system with a narrow tax base and highly regressive taxes falling largely on "consumption " to one with a considerably broader tax base and greater emphasis on direct, progressive taxes—several criticisms can be offered. First, the present surtax rates of the income tax would seem to be quite modest and could undoubtedly be increased, particularly above the 100,000 pesos level of income. Second, the extent of progression is seriously reduced by the existence of the sales tax with its present unusually high rate of 8 per cent. Third, it would seem that the National Government has not received sufficient revenue from the property tax, especially in view of the relatively high property values in Argentina generally, and especially in the Federal Capital and the National Territories. Fourth, although not evident from this study, there is great need for further strengthening and improving the collecting machinery.

SPIN-OFFS, SPLIT-UPS, AND SPLIT-OFFS

ROBERT S. HOLZMAN *

THE Revenue Act of 1951 as enacted upon October 20, 1951 created a new form of tax benefit: the spin-off. The concept actually is not new, and the form had been seriously considered when the Revenue Bill of 1950 was being drafted. Now that the spin-off is part of the corporate reorganization family, however, consideration must be given to its tax ramifications.

The listing below compares the tax effects of these three similarly-named tax phenomena.

DEFINITION

Spin-Off

"A spin-off occurs when a part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation without a surrender by the shareholders of stock in the distributing corporation." Senate Finance Committee, 1951.

Example. An existing company, O, transfers assets to a new company, N, in return for all of the N stock. O then distributes the N stock to the O stockholders.

Split-Up

"... a split-up occurs when a single existing corporation is replaced by two or more new corporations, the stock in the new corporations being distributed to the shareholders of the existing corporation which is completely liquidated." Senate Finance Committee, 1950.

Example. O transfers certain of its assets to N_1 for N_1 stock. The balance of the O assets goes to N_2 for N_2 stock. O assigns the N_1 and N_2 stock to the O stockholders in exchange for its own (O) stock; then O is liquidated.

Split-Off

A split-off occurs when part of the assets of a corporation is transferred to a new corporation and the stock in the latter is distributed to the shareholders of the original corporation in consideration of a surrender by the shareholders of part of the stock in the distributing corporation.

Example. O transfers certain of its assets to N for N stock. O assigns the N stock to its (O's) stockholders for part of their stock.

INCOME TAX CONSEQUENCES: CORPORATION

Spin-Off

Under Section 112(b)(4) O has no gain or loss on the transfer to N.

Split-Up

No tax consequences.

Split-Off

No tax consequences.

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INCOME TAX CONSEQUENCES: STOCKHOLDERS

Spin-Off

Tax-free under Section 112(b)(11), as added by the Revenue Act of 1951. But since the distribution of the N stock is tax-free to the O stockholders, their investment in the O stock must now be allocated between the O and N shares.

Split-Up

Tax-free.

Split-Off

Tax-free.

EXCESS PROFITS TAX CONSEQUENCES

1. *Partial Transfer of Assets*

Spin-Off. Where only part of the assets of a corporation go over to a new corporation in a tax-free exchange, the old corporation loses that portion of its base period experience which is allocable to the assets it loses in exchange, and the acquiring corporation (N) may utilize such experience in computing its average base period net income.

Split-Up. Where the assets of one corporation are split among two corporations, the base period earnings of the transferor (O) prior to the exchange are allocated among the corporations in business after the exchange (N_1 and N_2) in proportion to the fair market value of the assets of the old corporation which are held by each of the corporations after the exchange.

Split-Off. Where only part of the assets of a corporation go over to a new corporation in a tax-free exchange, the old corporation loses that portion of its base period experience which is allocable to the assets it loses in exchange, and the acquiring corporation (N) may utilize such experience in computing its average base period net income.

2. *Equity Capital*

Spin-Off. In a partial acquisition equity capital of the component (O) at the beginning of its first excess profits tax year is to be allocated to the acquiring corporation in the same proportion that equity capital transferred to the acquiring corporation bears to the equity capital of O immediately prior to the transaction; the amount so allocated will be deemed to be the equity capital of N at the beginning of its first excess profits tax year.

Split-Up. Same.

Split-Off. Same.

3. *Net Capital Additions and Reductions*

Spin-Off. The N stock as an inadmissible would probably be a wash entry.

Split-Up. Same.

Split-Off. Same.

4. *Minimum Excess Profits Credit*

Spin-Off. A new company would not be allowed the $25,000 credit unless it could be shown that obtaining this credit (and the surtax exemption) was not a major purpose of the creation of the new company.

Split-Up. Same.

Split-Off. Same.

THE PLACE OF THE CORPORATION INCOME TAX IN THE TAX STRUCTURE

HAROLD M. SOMERS *

FISCAL theory has suffered much in usefulness and reputation through a failure of the fiscal theorist to concern himself with the detailed provisions of individual taxes. Sometimes a policy recommendation is made for "an increase in taxation" without even specifying which taxes are involved. Sometimes the recommendation is more specific: "raise the corporation income tax"; "lower the personal income tax"; "impose a sales tax." But each tax can be formulated in innumerable ways and with a variety of economic consequences. Fiscal theory must include a study of the economic effects of different provisions of specific taxes if it is to be more helpful than harmful in making recommendations for policy.

Goode's book on *The Corporation Income Tax*[1] represents an important step in the direction of integrating a major segment of tax law and tax administration into the theory of public finance. The book is a comprehensive study of the corporation income tax in the United States. It is primarily concerned with questions of policy and particularly with the amount of reliance that should be placed on the corporation income tax in the revenue structure. It also deals with the nature and the detailed provisions of such a tax. In establishing the basis for these policy conclusions, Goode covers much legal and fiscal theory. It is in keeping with its character as a comprehensive treatise that this book necessarily covers a lot of familiar ground. It defines different types of corporations and includes a useful discussion of the relationship between ownership and control.

Goode describes the modern corporation as both a legal and an economic entity and considers whether the corporation should be taxed at all. He then plunges into the very difficult question of the shifting of the corporation income tax through commodity prices, wage rates, and security prices. He considers the effects of the corporation income tax on the distribution of income and wealth, its impact on savings and consumption, and on investment, national income, and employment. At a more specific level he discusses the problems involved in the measurement of taxable profits such as those concerned with inventory valuation, depreciation allowances, and interest and dividends paid. The questions of "double taxation" of dividends and the possibility of integrating corporate and individual income taxes are dealt with at considerable length. Finally, Goode makes an eloquent plea for the continued reliance on the corporation income tax in the revenue system.

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[1] Richard Goode, *The Corporation Income Tax.* New York: John Wiley & Sons, Inc., 1951. Pp. xiv + 242. $3.00.

Throughout his analysis Goode makes full use of available statistical data, some of which required a large amount of preliminary work on his part. One of the important contributions of this book is the collection and analysis of statistics concerning the distribution of dividends by income classes. Another noteworthy feature of the study is the integration of statistical data and sophisticated theoretical analysis. To reach policy conclusions in this difficult field and yet do justice to both the relevant statistical data and theoretical analysis requires not only a thorough familiarity with both but also sound judgment and great courage.

Shifting and Incidence

In his discussion of the shifting and incidence of the corporation income tax, Goode makes use of the best modern thought on the subject. He considers the three-fold claim that is sometimes made: the tax is borne by the shareholder, is passed on to the worker in the form of lower wages (and to the suppliers' capital in the form of lower interest and rents), and is shifted to the consumer in the form of higher prices. He considers both short run and long run aspects of this problem.

Goode shows particular awareness of the limitations of competitive price theory in the study of shifting and incidence. He notes: (1) that monopolistic or quasi-monopolistic conditions may prevail; (2) businessmen may regard the corporation tax as a cost and act accordingly; (3) that special problems are raised by the regulated utilities. He omits, however, the case where through inertia or neglect the prices are other than the optimum prices. The monopolistic or quasi-monopolistic case mentioned above implies that the price is kept below the optimum. But in the case of inertia and neglect the price may be either greater or less than the optimum. Then the imposition of the corporation income tax or an increase in rates of the tax may provoke the businessman into adjusting his price to the optimum. This may be either less or greater than the price that prevailed before the tax was changed.[2]

An important point which Goode makes—one that is often forgotten—is that even if we assume the businessman regards the income tax as a cost, we cannot conclude that the tax is shifted, provided that the firm is trying to maximize its profits. At the point of maximum profit, the marginal revenue equals the marginal cost, hence the marginal tax is zero; therefore the marginal cost that is attributable to the tax is zero. Thus the optimum point would not be changed even if the tax were considered as a cost (p. 50). Since a literal application of profits maximization is not feasible, especially in a large business with many products, one can expect that treating the income tax as a cost would probably result in some price increase and thus some shifting of the tax even though the price increase is not literally in the interests of profit maximization. The complexity of price setting in a multiproduct firm requires that profit maximization be considered in a broad sense which takes account of the administrative cost involved in making fine adjustments.

Goode emphasizes the difficulties involved in relating the theory of incidence to actual practice in the case of the corporation income tax. In particular, there is the question whether the legal definition of net income used for tax purposes coincides with the economic concept on the basis of which the theory of shifting depends (p. 52). He decides that the tax law definition of cost items is broader than the economic; hence, in practice, the income tax is entirely consistent with the theoretical concept and the tax rests on economic surplus (p. 54). However, allowances for management compensation in the calculation of the corporation income tax may be inadequate. In so far as this is true, the tax infringes on a cost and leads to some shifting in the short

[2] This point is developed more fully in Harold M. Somers, *Public Finance and National Income*, Chap. 13 (Philadelphia: The Blakiston Company, 1949).

run. Another possibility lies in the use of the straight line method of depreciation year in and year out, when actually the loss in economic value may be greater than the loss in value taken into account by the depreciation allowance. Where this occurs, the accounting profit exceeds the economic surplus. The income tax then infringes on cost and may be shifted in the same way as any tax on costs.

Goode also has an interesting discussion of the possibility of shifting the corporation income tax in the long run. He rejects the conclusion that there will be a *general* increase in commodity prices and suggests that there will be "a long-run increase in relative prices of commodities in whose production the corporate form is especially advantageous . . ." (p. 57). His discussion requires elaboration in several respects.

A major factor in the decision to undertake capital investment—that is, a major factor in any long run decision—is the relative desirability of the business investment and the alternative of holding a relatively riskless government bond or bank deposit. If the tax brings the expected net return from a business investment below the actual or psychic return from alternative holdings, the investment will not be undertaken. For instance, a person contemplating an investment of $10,000 may estimate that on an additional $1,000 he will acquire a return of 3 per cent. If the alternative rate is above this, say 4 per cent (in the form of either actual or psychic return), he will decide to hold the alternative securities or cash rather than to make the additional business investment. An increase in corporation income tax rates will tend to depress most expected returns, but it will not affect tax-free municipal bonds nor will it affect the psychic return derived from holding cash.[3]

In this way the corporation income tax will tend to reduce the volume of business investment. If corporation income taxes have the effect generally of depressing expected rates of return, we may become conditioned to the lower rates and thus change our attitude concerning the holding of idle cash. It is quite conceivable that the imposition of high corporation and personal income taxes will have the effect of ultimately conditioning investors to accept a lower rate of return. There will nevertheless be some curtailment of investment as a result of the corporation income tax, although the amount of such curtailment will be reduced.

Goode reaches the conclusion that "all the taxes curtail investment to some extent" (p. 152). Few people will quarrel with this conclusion. Nevertheless, we cannot neglect the possibility of a backward rising supply curve of investment. Is it likely that increased taxes *induce more investment* in order to maintain a given amount of return? In other words, taxes may to some extent have an incentive effect much like that which they sometimes have in a case of labor. It is also interesting to note that Goode reaches the conclusion that the corporation income tax curtails private investment somewhat more than individual income taxes and decidedly more than excise or payroll taxes.

An important extension of the theory of tax shifting is made by Goode when he considers the indirect effects of demand on the price level. Demand enters the picture in two ways: (1) the change in investment will affect the level of employment and income, hence of demand; (2) the revenues derived from the corporation income tax will be spent by the government (pp. 58-61). The first of these is undoubtedly important in any complete analysis of the shifting of the corporation income tax. The chain of events is: the tax is imposed, investment is reduced, income and employment are reduced, hence the demand for the finished product is reduced, thus the price level will change. The only difficulty is that (according to our analysis) [4] we can-

[3] Somers, *loc. cit.*

[4] *Ibid.*

not tell whether the reduction in investment will result in an increased, a decreased, or an unchanged cost per unit. Granted that the demand is reduced, we still cannot be sure whether the net result is a higher, a lower, or an unchanged price. The economic effects in terms of reduced income and employment are fairly clear, but the change in price, that is, the shifting of the tax, is not at all clear.

The fact that the government will spend the tax money is important in the total picture, but it also brings up a troublesome question of the technique of analyzing tax shifting. It is generally true, and especially so in a period of defense mobilization, that the level of government expenditures is not limited by the availability of tax revenues, least of all by any particular tax revenue. It is desirable to take account of the effects of government spending in considering the total effects of the budget both as to price, that is the inflationary or deflationary effects, and as to income and employment. But the main purpose of the analysis of the shifting of an individual tax and the main purpose of Goode's book is to consider one tax in relation to alternative taxes. The nature and volume of government expenditures is the same in all cases. Thus the inclusion of government expenditures in the analysis of the shifting of an individual tax does not contribute to the understanding of the problem of tax shifting. At one point in his analysis of tax shifting, Goode does make use of the assumption of given expenditures, and he presents a very sound discussion of the significance of this assumption (pp. 164-5). Goode also makes the important point that a tax reduction tied to an equal decrease in expenditures may actually reduce the national income.

General Economic Effects

In his analysis of the effects of the corporation income tax, Goode makes use of the working hypothesis that the tax rests on corporation profits. Similarly, he uses the working hypothesis that excise taxes rest on consumers and that individual income taxes rest on individuals. He admits, of course, that the hypothesis concerning the burden of the corporation income tax is not fully consistent with the analysis of incidence in his chapter on the subject (p. 75). This working hypothesis points up very sharply the basic problem involved in trying to determine the effects of the corporation income tax. A sophisticated analysis of the incidence of the corporation income tax (including Goode's analysis) does not by any means warrant the conclusion that the corporation income tax will generally rest on corporation profits. The analysis of effects is thus vitiated to a great degree.

There is a valuable discussion of the effects of the corporation income tax on wages, a much neglected subject. Goode suggests that large corporate net profits give companies increased staying power in union disputes (p. 66). From another point of view, however, high rates of corporate taxation reduce corporate resistance to increased wages. Since wages are deductible expenses, the higher the rate of corporate taxation, the smaller the proportion of wages that the company has to pay out of potential profits (p. 65). This is particularly noticeable where we have an excess profits tax. The existence of a large demand for the product is a necessary condition for such an attitude of acquiescence in wage requests since the demand is reflected in enlarged profits. Thus under conditions where we have the expectation of continued large profits (which imply a *flexible* price control, if any) and also high tax rates, we are likely to find a very soft attitude towards wage increases.

Goode also suggests that, if the corporation income tax leads to a decline in investment and national income, there will be a reduction in both the wage bill and the wage rates; government spending, however, will offset this tendency (p. 67). Again the net effect of the corporation income tax on wage rates is indeterminate.

In considering the effects of the corporation income tax on income and employment, Goode also takes account of various administrative and technical problems. Moreover, he includes both aggregative and price theory analysis, and he tests the consistency of the corporation income tax with the objectives of fiscal policy. He also takes into account the alternative means of financing a given volume of expenditures. He emphasizes that there is no point in considering the effects of the corporation income tax alone without considering the advantages and disadvantages of the alternatives.

Double Taxation

The question of double taxation is discussed from the point of view of the progressivity of the tax structure (p. 96). Since the personal income tax is highly progressive while the corporation income tax is relatively nonprogressive, the exemption of dividend income from taxation would reduce the progressivity of the tax structure. If the undistributed portion of corporate income were exempted from taxation, there would be a greater amount of earnings to be reinvested. Any resulting capital gain would be subject to the low rate applicable to long term gains. Thus again the removal of double taxation would reduce the progressivity of the tax structure.

Even if the present degree of progressivity were accepted as desirable, and even if it were agreed that the double taxation of corporate income contributes to the progressivity, there is still a question whether the progressivity could not be achieved without the "double taxation" feature. For instance, if corporate earnings were taxed on a partnership basis, the earnings would be subject to the progressive individual income taxes, yet double taxation would be eliminated. The advocate of the elimination of double taxation would, however, view this with alarm because it would subject reinvested earnings to the high rate of the individual income tax.

Goode also makes a point that is often neglected, namely, that "double taxation" is a common phenomenon. The same tax base is frequently subjected to two or more taxes. He indicates that the mere existence of "double taxation" does not in itself indicate injustice. Otherwise a large part of our tax system would have to be considered at least equally unjust (p. 24). One example is the existence of federal, state, and local income taxes. Incidentally, Goode presents a justification for state income taxes (p. 41) but he neglects one important disadvantage—the problems of allocating income between various states. The complicated allocation formulas that exist testify to the difficulty of these problems.

Accelerated Depreciation

Goode makes a case for the use of accelerated depreciation even in ordinary times when the question of amortization of emergency facilities is not involved. The immediate effect of accelerated depreciation is that of tax reduction (p. 216) (provided that profits are being made). During the period of accelerated depreciation the tax revenues must be less than they would have been under the system which allowed a slower rate of depreciation, thus smaller depreciation allowances, during those years. After the initial period of accelerated depreciation (e.g., five years) tax revenues may rise as a result of this procedure. As a starting point, if we assume that there is no new investment but that the fully-depreciated facilities still exist and produce income, tax revenues would be greater in those later years than they would otherwise have been. In so far as new profitable investment takes place during the second five-year period, there would be a smaller tax with respect to that new investment

than would otherwise have occurred. But it is necessary to balance this smaller tax on the new investment against the larger tax on the amortized investment. Thus after the initial period of the introduction of the system of accelerated depreciation, there may be no significant change in the tax revenues; or, in any case, the tax revenue may be higher in some years and lower in other years, depending on the amount of new investment relative to amortized investment. If there are elements of progressivity in the corporation income tax, accelerated depreciation might even increase tax revenues over the entire period of the life of equipment. For instance, if we assume ten-year amortization on equipment that produces a stable income for ten years, a corporation will be subject to certain medium rates of taxation throughout the period. But if the equipment is written off completely during the first five years, the rates during those years will be lower, while during the second five years the rates will be more than proportionately higher if there is progression. We may take a case where there are three brackets—40 per cent, 50 per cent and 65 per cent. In the case of stable income over the ten-year period, all the income might be subject to the 50 per cent bracket; but in the case of lower income in the first five years and correspondingly higher income in the second five years, we may find that the taxes are 40 per cent in the first five years and 65 per cent in the second five years. The result is that the total tax for the full ten-year period is greater than if there had not been any accelerated depreciation. This case is exactly analogous to the penalty imposed on people with fluctuating income as opposed to those with stable income.[5]

Goode ignores the serious disadvantages of a plan of accelerated depreciation if it is installed on a compulsory basis. Once the facilities are written off, they may continue to produce income for many years. Since the depreciation allowances are exhausted, however, the taxable income in those years tends to be higher; hence the taxes tend to be higher than would be true if the depreciation were spread over a greater number of years. The horizon of businessmen is generally short enough so that a five-year amortization acts as an inducement. In some cases, however, there is a period of development during which profits are very low and perhaps even losses occur. In that case, it might be a greater inducement to permit higher rates of depreciation in later years than in earlier years. In such cases, compulsory accelerated depreciation would constitute a discouragement of investment.[6] The cyclical effects must also be considered; investment may be encouraged precisely when some tempering of expansion may be in the best interests of stability at a high level of activity.[7]

With respect to inventory valuation, Goode is opposed to the Lifo method on the plausible ground that it aggravates a cyclical fluctuation by increasing taxes in depressions (p. 171). He also presents a good argument against the current cost method of depreciation, claiming that holders of fixed assets gain from inflation in other ways and should not be given this additional benefit (p. 174).

There are also a number of valuable discussions on specific points. For instance, there is a very sophisticated analysis of anticipated returns (pp. 114 ff.). There is also a well-rounded consideration of loss offsets, including the possibility of negative taxes (p. 122). There is a sound emphasis on demand throughout the book.

Conclusion

Goode's book clearly represents an important contribution to the field of taxation. It is a good illustration of the best work that has been done by members of the re-

[5] See Somers, *op. cit.*, pp. 320-325.

[6] *Ibid.*, p. 319.

[7] *Ibid.*, p. 320.

search division of the Treasury Department, with which Goode was associated for a number of years. It shows an awareness of political problems, especially in the discussion of the various plans designed to eliminate double taxation of corporate earning (p. 198). In his more general sections, Goode has a tendency to make very broad statements regarding fiscal policy, some of which require further consideration before definite conclusions may be reached.[8]

This is precisely the type of work that is needed in the field of public finance. It is both quantitative and theoretical. It integrates the best of economic analysis with the best statistics available. It is, of course, inconclusive on many points, as the author himself admits. But the inconclusiveness is evidence in this case of the sophistication of the analysis and the lack of dogma. The book takes its place with the research studies that have been put out by the Harvard Business School as an important contribution to our understanding of the tax structure. Goode throws a clear light on many aspects of the corporation income tax and removes many misconceptions that exist concerning it.

[8] See, for instance, Goode, *op. cit.*, p. 209.

BOOK NOTES

The Indiana Gross Income Tax. By Kenneth C. Back. Lexington, Kentucky: University of Kentucky, 1950. (Bureau of Business Research Bulletin 23.) Pp. 114. $1.00.

Under pressure to find additional sources of revenue, the Kentucky Department of Revenue requested the University of Kentucky Bureau of Business Research to make a study of the Indiana gross income tax. The survey was begun in late 1948 and the results are published in this book.

The author describes in some detail the nature and historical development of the tax and its administration in Indiana. In general, however, main emphasis is given to an analysis of the broad economic effects of the tax during the ten-year period, 1939-1949. The conclusion is reached that the "Indiana gross income tax evidently does not unduly impair productivity or have any major ill effects upon the economy of the state. No evidence is available indicating business integration to avoid the tax. . . . Experience suggests that the gross income tax is a relatively insignificant factor in influencing industry and business to or from the state."

The tax yield has surpassed the most optimistic expectations, and because of its simplicity, compliance is easy for most taxpayers. However, inasmuch as the tax is based upon gross receipts, it can take no adequate account of ability to pay. Tax liabilities are incurred without regard to net gain or loss or differential expenses of doing business. "The tax has all the defects of the family (of sales taxes), plus three of its own—an extraordinary uncertainty as to incidence, a tendency to pyramid the rates, and an unusual volume of administrative work."

Oil and Gas Federal Income Taxation. By Kenneth Miller. 2d Edition. Chicago: Commerce Clearing House, Inc., 1951. Pp. 284. $7.50.

This book, written for the practicing tax attorney, seeks to correlate the law, regulations, rulings, and decisions applicable to the highly specialized income tax problems of the oil and gas industry. Mr. Miller is manager of the Tax Department, Houston office of Arthur Young and Co., and a member of the Houston and Texas Bars.

Income Taxes in the Commonwealth, Volume I. London: H. M. Stationery Office, 1951. Pp. iv + 426. 18 shillings.

This authoritative volume, prepared by Inland Revenue, is a convenient summary of the income tax laws of Australia, Canada, Ceylon, India, New Zealand, Pakistan, and the Union of South Africa. It covers laws of the states or provinces as well as those of the central governments. Each system is treated separately and is separately indexed. Information is included on the scope of the income taxes, computation of income and deductions, rates, international double taxation agreements, and miscellaneous provisions. Useful features are specific citations of the statutes on each subject and an explicit statement of the latest tax year covered by each compilation. Annual supplements will be issued to keep the book up to date. A second volume dealing with the remainder of the Commonwealth is in preparation.

Municipal Nonproperty Taxes—1951 Supplement to Where Cities Get Their Money. By MUNICIPAL FINANCE OFFICERS ASSOCIATION OF UNITED STATES AND CANADA. Chicago, 1951. Pp. 47. $1.50.

This study, the most recent of a long series made by the Municipal Finance Officers Association, is intended to explore the use of nonproperty taxes, to determine how many cities are now using them, to cite some administrative experience, and to analyze, to some extent, their general importance to municipalities using them. The study is limited primarily to the following taxes: (1) sales; (2) income; (3) gross receipts business licenses: (4) taxes on public utilities; (5) cigarette and tobacco taxes; (6) taxes on alcoholic beverages; (7) taxes on motor vehicles, other than ad valorem; (8) motor fuel taxes; (9) admission taxes. It may be noted that three very important nonproperty revenue sources are omitted from this list: (1) flat rate licenses; (2) state and federal grants-in-aid; and (3) service charges for current municipal services.

In recent years municipalities have greatly intensified their search for new revenues. This supplement in combination with its predecessor volumes presents a valuable record of the changing importance of different sources of municipal revenues.

The Municipal Business Tax in Canada. By ROBERT M. CLARK, Ph.D. Toronto: Canadian Tax Foundation. Canadian Tax Papers, No. 5, February 29, 1952. Pp. 54. $1.00.

As used in Canada, the term " municipal business tax " generally refers to a tax on persons imposed by reference to the value or the area of premises occupied for business purposes. Three bases of assessment are in use: a fraction of the property assessment; the annual rental value of the premises; and the area of the premises. The tax has no exact counterpart in the United States, the nearest approach being New York City's occupancy tax on persons renting business premises for gainful purposes. In Canada, however, the tax is found among municipalities in nine provinces, and in larger cities it typically produces from 12 to 20 per cent as much revenue as the property tax.

Dr. Clark writes with two purposes in mind: to describe the background, form, and fiscal importance of the tax; and to state and analyze current opinions of the tax. Present methods of levying the tax inevitably produce serious inequities, and what is needed, in Dr. Clark's opinion, is the eventual substitution of some form of income tax. The immediate situation could be helped, however, by " elimination of the gross discrimination inherent in some of the classification systems," and " by introduction of a low business tax assessment exemption for all businesses."

This book is the most recent of a series of studies of Canadian tax problems sponsored by the Canadian Tax Foundation, a nonprofit research organization established in 1946.

1953 CONFERENCE TO BE HELD IN LOUISVILLE

If you are so forehanded as to have your 1953 calendar pad, please note on it that the 1953 National Tax Conference will be held in Louisville, Kentucky, on September 28 to October 1, inclusive. The Brown Hotel will serve as conference headquarters. Located very near the geographical center of our membership and in the home state of our new president, Commissioner H. Clyde Reeves, this site should attract one of the largest attendances of recent years.

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